The Economic Framework for Monitoring and Holding Corporate Management to Account

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It is alleged that there are twelve main reasons which possibly affect investors' willingness to hold corporate managers to account. These reasons are: thin equity; diversification; liquidity of shares; reliance on other investors; apathy of shareholders' agents; keeping access to soft information; comparison with other investment managers' performance and market indices; conflict of interests; short termism; corporate managers' manipulation of the general meeting's agenda; political retaliation; and, investing in index funds. By gauging institutional investors and investment managers' opinions, this paper examines whether or not these alleged reasons are truly inherent in the economic framework of the UK market which necessarily affects at least some institutional investors and investment managers' willingness to hold corporate managers to account. This paper gives a useful insight into respondents' opinions about these twelve reasons, concluding that the economic framework of the market fails to support institutional investors and investment managers in holding corporate managers to account.

Keywords: Institutional investors' activism; institutional investors' apathy; and, corporate governance

1. Introduction

The UK Companies Acts 2006 provide the constitutional machinery for the governance of UK companies. The provisions in the legislation regarding the holding of general meetings by shareholders, the role and responsibility of directors, the nature of the articles of association and the memorandum of association are complemented by the role of the auditor reporting on the accounts, and the freedom of companies to use or adapt model constitutional documents that is most appropriate for their company.

This system is supported by rules developed by the courts; laying down the duties of directors, recognising the division of functions between the board of directors and the general meeting and applying the general law of contract, trusts and agency. In addition, for listed companies, the Listing Rules promulgated by the Financial Services Authority, in its capacity as the UK Listing Authority, requires a substantial additional level of transparency and disclosure. In reading only the legislation and the constitutional documents of companies, one could be forgiven for seeing a clear and straightforward legal

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model of corporate governance based on a concept of ‘shareholder democracy’. According to sections 160 and 168 of the UK Companies Act 2006 for example, shareholders/members elect and can remove directors who owe legal duties to the company to pursue its interests. The legislation and the company’s constitution stipulate which powers are vested in the board and which belong to the shareholders, leaving the power to amend the constitution to the latter (sections 21 and 30 of the Companies Act 2006). In addition, the courts as in the case of *Breckland Group Holdings Ltd* v *London & Suffolk Properties Ltd*[1] have ruled on the nature of that division of power and its implications, embracing the model that it is the role of the board of directors to manage and run the company on a day to day basis without shareholders’ interference, while the general meeting decides on the company general policies and holds corporate managers to account.

Yet, since the early 20th century, literature in the area of corporate governance began to envisage a problem in the corporate governance system; namely, the separation between ownership and control. Veblen (1904 and 1921) was probably the first writer to observe the phenomenon of ‘separation between ownership and control’ in modern corporations. Veblen examined this phenomenon apparent in the modern corporation, in which he described the emergence of a ‘new’ kind of economic actor: the ‘manager-engineer’. In the 1930s, following on from Veblen’s work, Berle and Means argued that, in the case of a listed company with shares widely dispersed in small parcels among a large number of investors, there exists a separation of ownership and control; to such an extent that the constitutional mechanism of large corporations would fail to hold corporate managers to account. This argument is based on the availability of the option of selling a stake in a company on the stock market and the wish of shareholders as investors to maximise their return and minimise their costs, rather than spending money and other resources such as coalition building and participation in the ‘shareholder democracy’ system.[2]

In contrast, Stapledon (1996) and Gaved (1997) testify that a remarriage has taken place between ownership and control in today’s market. This is based on the fact that there have been profound changes to the share ownership structure of public listed companies, making institutional investors and investment managers the obvious contenders to be the ultimate power in UK and US public listed companies. Although this paper acknowledges that there are some examples of institutional shareholders’ activism, the situation is still very short of one claiming that there is an effective system in place to hold management accountable in listed companies. The author therefore argues that the market custom and over-regulation are to be held responsible for the lack of institutional investors and investment managers’ “willingness” and “ability” to take initiatives in monitoring and controlling public listed companies’ managers.

Arguably by and large, investors can be divided into three different categories in relation to the monitoring and controlling of corporate managers. These are namely: active investors (i.e., have a policy in place to monitor all investment

portfolios and do so continually); inactive investors (i.e., do not have a policy in place to monitor investment portfolios or might have, but in actual fact do not monitor); and, potentially active investors (i.e., have a policy in place to monitor all investment portfolios but only do so if it is viable and economically sensible). If shareholders wish to monitor as a matter of policy, then they may do so regardless of the number of shares that they hold in a company. Indeed, some shareholders do have such a policy. One institutional investor in this study, for example, stated: '[c]learly smaller per cent holding = Less impact on portfolio performance. However, we monitor performance of all companies in portfolio.' (Institutional investors' questionnaire, control number, (II, hereafter) 104). Other institutional investors (IIs 133, 234) affirmed: '[a]ll shareholdings are worth managing to achieve best results.'

Inactive investors usually rely on others to do the monitoring and/or exit, when available. The third type of investors, which could arguably be the majority of shareholders, may wish to monitor management but are deterred from monitoring because of the cost of doing so. Most shareholders, including institutional investors and investment managers, do not have the weight as individual shareholders (i.e., when not acting in concert with other shareholders) to monitor and hold corporate managers to account, in order to achieve a sounder corporate governance system. Hence, for viable monitoring, collective action between shareholders is needed. This paper however, principally focuses on institutional investors' and investment managers' attitudes towards reasons that allegedly affect the third type of investors who have a policy in place to monitor and control corporate managers on the condition that it is economical to do so.

The dilemma therefore, that some shareholders may face when considering to monitor corporate managers is whether it makes economic sense to do so. For some shareholders, it might be a matter of the size of their stake and whether it is worth making an effort to make the corporate governance system within the company which they invest, sounder. For such shareholders, at times but not as a matter of policy, selling shares may be the easiest option. II 38 for example stated: '[s]maller shareholders are more likely simply to switch investment if dissatisfied.' The equation for this type of investor may sometimes be as simple as: 'is the expected added value greater than the potential cost?' If so, only then, would monitoring be exploited.

Significantly, the empirical data collected for this study revealed that some institutional investors, especially those who employ external equity managers, believe that investment managers should monitor corporate managers. II 3 for instance, stated, '[i]nvestment managers should monitor each and every [company]… it is their primary function'. However, the problem that might arise from the latter approach is that this form of agency cost of monitoring might be passed from one agent to another, (i.e., from corporate managers to investment managers). This is because, when such institutional investors fully rely on their external investment managers to monitor corporate managers, there should be a mechanism put in place to make sure that investment managers are actually delivering what institutional

investors want them to deliver. Such a mechanism should always underpin what is asked by institutional investors to be delivered, as well as what is actually delivered. Furthermore, reliance on external investment managers should not be based on a vacuum. There should be a monitoring policy put in place by institutional investors on how and what to monitor, which could then be directed to external investment managers to be implemented. After which, institutional investors should monitor what external investment managers have achieved so far as monitoring and controlling corporate managers is concerned.

Legal scholars such as Coffee (1991) Black (1990) and Stapledon (1996) have suggested that there are at least twelve intrinsic factors that separately, as well as collectively, cause investors' apathy. These are: thin equity; diversification; liquidity of shares; reliance on other investors; apathy of shareholders' agents; keeping access to soft information; comparison with other investment managers' performance and market indices; conflict of interests; short termism; corporate managers' manipulation of the general meeting's agenda; political retaliation; and, investing in index funds. This paper empirically examines whether or not these alleged reasons are truly inherent in the economic framework of the UK market which necessarily affects at least, on general terms, some institutional investors and investment managers' willingness to hold corporate managers to account. Such reasons could indeed in turn, for example, affect the ability of shareholders to force socially responsible policies upon less socially responsible boards.

2. Data Collection and Research Methodology

The author embarked on obtaining empirical evidence regarding whether investors in the UK market approve of the twelve reasons as suggested by some legal scholars such as Coffee (1991), Black (1990) and Stapledon (1996) in relation to what might cause investors to be inactive. In consideration of the sample for this study, it would have been perhaps too ambitious to examine all groups of shareholders. The fact that institutional investors hold the majority of today's corporation makes them the obvious candidates to hold corporate managers to account. The influence of institutional investors, as a driving force for any potentially successful attempt to hold corporate managers to account has also been acknowledged by many academics, including Holland (1995) and Gaved (1997), who observed that institutional investors held 75% of the major UK companies in 1996, with UK institutional investors owning approximately 60% of shares in UK companies. However, the most recent survey shows that institutional investors hold only about 50% of London Stock Exchange's shares (Office of National Statistics, 2005). Furthermore, the fact that pension funds and insurance companies hold the vast majority of institutional investors' shares makes them the most appropriate candidates when it comes to possible coalition building. Investment mangers were also included in the study as they manage most pension funds.

2.1. Response Rate

The first questionnaire was sent to all the member institutions of the NAPF and the ABI, totalling at 867 institutions. The second questionnaire was sent to all investment managers that invest for insurance companies and pension funds, totalling at 132 investment managers.[3] The collective size of the institutional investors who completed the questionnaire is £413 billion and their collective investment in LSE as for December 2000 was £194 billion, £150 billion of which is invested in house and 44 billion invested externally.
On the other hand, the collective size of shares held and managed by the investment managers who completed the questionnaire is £205 billion.[4] Given the sensitivity of the data that institutional investors and investment managers were asked to provide, the questionnaires were designed to gage opinions of what happens in practice (generally) rather than what their practice is in theory. Hence, the data collected for this study represents the opinions of the respondents, rather than what happens in their organizations.

3. Possible Reasons for Investors' Unwillingness to Monitor Corporate Managers

This section considers the twelve reasons suggested by Coffee (1991), Black (1990) and Stapledon (1996) that might cause investors to be inactive.

3.1. Thin Equity

In this study, thin equity was considered to be when a shareholder's holding of a company was less that 3%. This is because 3% is the point at which the law (section 199 CA 1985) treats a shareholder as having a noticeable interest in a public company, and also represents the average in which shareholders consider their shareholdings as significant. The question that was asked to both institutional investors and investment managers was, 'do you think thin equity (i.e. when the holding is less than 3%) might be a reason for investment managers' and shareholders' inactivity in monitoring corporations and their managers?'

One could argue that the more significant the holding, the stronger the motivation for activity in monitoring corporations and their managers. On one hand, the level of impact on corporate governance issues increases as the size of the holding increases and, on the other hand, if a shareholder's holding was insignificant, it might be easier to sell it. It is not easy for shareholders and investment managers that hold significant shareholdings to sell without loss, regardless to the size of the listed company itself. However, it may be even more difficult to sell without losses in a large capital sized listed company such as those in the FTSE 100. Hence, the bigger the investment and the larger the corporate capital size, the bigger the risk of experiencing a loss when disposing of that investment. In relation to this, investment managers' questionnaire, control number (IM hereafter) 222, thought that one needs to give a discount when selling significant holdings.

The example given was: '… a 4% holding might need to be sold at a 4% discount to the best bid'**.**

The counter argument is that some investors would like to buy (for strategic purposes and not least so that they would have a voice) in big quantity, which might make a significant holding more valuable in case of a takeover, for example. However, this is rather unlikely to happen if shareholders are dissatisfied with company performance itself, rather than the management or its strategy. For example, II 38 stated: '[d]ifficult to move large shareholding unless the company shares are in demand in which case investor unlikely to be dissatisfied with corporate managers'. II 160 made the point that: '[i]t depends on how much over 3% holding is and how many other large holders have the same mind.' This quote suggests that there is also a correlation between the liquidity of shares and being able to sell without a loss. Six institutional investors and two investment managers linked exiting the company at a significant level without a great loss to the liquidity of the company's shares.

It is conceivable however, that shareholders would use marketing techniques to sell their shares if they knew or even suspected that a problem in the company was imminent. One of those techniques is to distribute the selling of shares into small parcels over a period of time. II 378 stated: '[w]ill need to spread the sell over time to avoid loss.' II 320 similarly said: '[s]ometimes over time, but this is the advantage of quotation.' In attempting to gain a more in depth understanding about what happens in the market concerning selling without a loss, institutional investors and investment managers were asked how often they had the option of exiting the company (without great loss) when dissatisfied with corporate managers, (if holding shares 3% or more).

Table 1 (see attached appendix) shows that the vast majority of institutional investors believe that exiting the company without great loss if dissatisfied with corporate managers is 'frequently', 'occasionally' or 'rarely' a possibility, depending on the circumstances. 60.8% believed that this possibility occurs frequently or occasionally. Just 2% believed that such a possibility never occurs. Given the fact that the question used the wording 'great loss' the fact that over 53.9% of institutional shareholders thought that the possibility of exiting without a great loss only occurs either occasionally or rarely seems significant. The results of the investment managers' questionnaire were almost identical to the results of the institutional investors' questionnaire. Table 1 shows that all investment managers believed that exiting the company without great loss if dissatisfied with corporate managers is a possibility that occurs, depending on circumstances, frequently, occasionally or rarely. 71.5% believed that the possibility occurs frequently or occasionally.

Institutional investors and investment managers were asked whether thin equity is a reason for inactivity in monitoring companies' managers. Table 2 shows that 41.2%, of institutional investors thought that thin equity is a reason, whereas 35.3% thought it is not and 16.7% were not sure. The response of investment managers was very different, however. Table 2

shows that the vast majority of investment managers (57.1%), thought thin equity is not a reason for inactivity, whereas just 14.3% thought that it is. One may argue that this is due to the fact that more investment managers take the issue of monitoring as a firm policy. Clients also expect investment managers (who act as external equity mangers) to monitor. Additionally, investment managers normally have bigger investments to manage than institutional investors, as they often have combined holdings for different clients in any particular company.

3.2. Liquidity of Shares

Liquidity of shares is thought to be a reason for inactive monitoring among shareholders and investment managers. Some might have a prime interest in return rather than operational changes in the company. If so, then liquidity of shares would make selling shares achievable. This is because as IM 121 put it, '[s]elling is a trouble free way of escaping time consuming corporate governance issues.' Furthermore, it has been suggested that shareholders would look at the liquidity of a company's shares, before committing themselves to significant holdings of 3% or more. For example II 146 asserted: '[w]e would only build up a large shareholding in a company if the secondary target was sufficiently liquid.' Yet, there are shareholders who believe in monitoring as a policy, regardless to whether or not the shares are liquid.

Table 3 shows that 38.2% of institutional investors considered liquidity of shares as a factor that deters investment managers and themselves from monitoring corporations and their managers, while 40.2% believed it is not a factor. The results from the investment managers' group, however, were different. Table 3 shows that a majority of 57.1% of investment managers believed liquidity of shares to be a reason for shareholders' and investment managers' inactivity in monitoring corporations and their managers, while 42.9% of investment managers believed it not to be a reason. Hence, while some investment managers (if they are locked in the company) may monitor, it is not investment managers' prime objective to monitor corporations and their managers. As one IM 222 stated, '[i]nvestment corporate managers is difficult and highly competitive – monitoring corporate managers is quite a long way down our list of priorities'.

3.3. Diversification

Investment diversification is a widely accepted notion in reducing risk. This method of investment is widely used by risk–averse investors. The belief held is that the greater number of securities, the lower the risk (Arnold, 1998, p. 262). 40.2% of institutional investors believed that diversification of investment might be a reason for inactivity in monitoring corporations and their managers while 36.3% thought it is not. However, (as shown in table 4) a majority of 57.1% of investment managers deemed it not to be a reason, while only 35.7% thought that it is. Interestingly, institutional investors were almost consistent in perceiving diversification and liquidity of shares as

reasons for inactivity in monitoring corporations and their managers. However, while 57.1% of investment managers thought that liquidity of shares is a reason for apathy, the same percentage of institutional investors (57.1%) thought that diversification is not. It is worth noting the similar responses given by investment managers in relation to thin equity (see, Table 2). Here, institutional investors' opinions about diversification were also very similar to their responses on thin equity (Tables 2 and 4). Of course, there is an obvious link between diversification and thin equity i.e., both reflect investors' perception of risk and serve the purpose of spreading investments to minimise risk.

3.4. Reliance on Others in Monitoring Corporations and their Managers

Reliance on others to monitor corporations and their managers can take three forms. Namely: 'free riding'- the reliance on other investors or investment managers; reliance on other organisations such as the NAPF or ABI (Bromwich, 1992); and, reliance on external investment managers. Concerning, the second and third forms of reliance, there is normally an agreement (explicit or implied) between the clients/members and the organisation that performs such a duty. However, there is no doubt that as far as achieving good corporate governance is concerned, the worst form of reliance is free riding.

The most important reason for the free riding phenomenon, is cutting cost (agency cost) in the short term. Table 5 shows that 57.1% of investment managers thought that reliance on others could be a reason for inactivity. Yet, according to Table 5 just 37.3% of institutional investors thought this to be the case. However, that is not to suggest that institutional investors are more proactive than investment managers. Actually, some institutional investors' comments suggest that they perceived the issue of monitoring corporations and their managers as a battle for investment managers to fight and that, if reliance on others exists as a reason for apathy in monitoring, then it exists among investment managers only. For example, II 104 said, '[s]ome fund managers better equipped than others (e.g. resources) to initiate corporate managers' changes.' Table 5 divulges that the responses from investment managers here are identical to their responses on liquidity. Hence, there is a possible correlation between liquidity of shares and reliance on others to monitor (Tables 3 and 5). There is also a possible correlation in the investment managers' group between thin equity and diversification (Tables 2 and 4).

3.5. Comparison with Other Investors

The issue of reliance on others to monitor corporate managers, particularly free riding, could be linked to comparison with the performance of other investment managers and market indices. Comparison with other

investments means that institutional investors and investment managers might not be willing to monitor corporations and their managers when the price of monitoring reflects on their performance, compared with other institutions and investment managers and the market indices. Some shareholders might be at an advantage monitoring, even if they individually bear the monitoring cost. This is particularly the case when investors hold a large stack in a corporation. However, monitoring is not always linked to better market value performance. It might be linked to a policy preference to implement socially responsible investment, for instance. As Table 6 suggests, the majority of the respondents from both groups did not consider comparison with other investment managers' performance and market indices to be a reason for inactivity in monitoring corporations and their managers. Specifically, 65.7% of institutional investors and 57.1% of investment managers did not perceive these two factors as reasons for apathy, while 28.6% of investment managers and 18.6% of institutional investors thought they were.

It is interesting that responses dropped dramatically. For example, institutional investors' response rate dropped from around an average of 40%, agreeing with the reasons provided, to less than 20%. Comments on this question reveal the reasons for the dramatic drop: for example, four institutional investors and two investment managers stated that comparison is a reason for active monitoring rather that the reverse. II 3 said that the effect of comparison is, '[r]ather the reverse – performance measurement implies significant monitoring of companies' is necessary'. What is interesting is that some investors see an even better potential in monitoring as opposed to free riding. Hence, rather unexpectedly, some investors see a comparison with other investment managers' performance and market indices as an actual incentive for monitoring. This suggests that some investors do believe in the effectiveness of monitoring and its ability to produce better corporation performance.

3.6. Agent's Apathy

This reason is of particular importance as around 87% of institutional investor respondents employ external equity managers. It was initially expected that a low percentage of institutional investors would believe that investment managers were inactive, and even a smaller number of investment managers. Surprisingly, the largest group of institutional investors (38.2%) (Table 7) regarded agents' apathy as a reason for inactive monitoring of corporate performance. The results (not unexpectedly), extracted from the investment managers' questionnaires were rather the reverse. The largest group of investment managers (42.9%) thought it not to be a reason. A minority of 28.6% of investment managers agreed that agent apathy was a cause for inactivity (Table 7). However, although the minority of 28.6% agreed, it is an extremely significant figure considering that it was a view taken by investment managers themselves. This is because such a response implies that investment managers believe they themselves or some of their competitors are performing to a high standard.

3.7. Demand for Soft Information

The sophistication of investors in the UK has no doubt made companies invest in good relations with their investors, which in turn led to constant company-investor relations in the 1990s (Bence, Hapeshi and Hussey, 1995). In particular, it has been shown that companies invest time in the development of strong relationships with their institutional investors, investment managers and analysts (see, Marston, C. 1999). The fact that institutional investors and investment managers hold and mange quite a large stock in listed companies has highlighted the importance of dialogue between both institutional investors and their investee companies (Marston, 1999; see also Gaved, 1997 and Holland, 1995). Apparently, the importance of dialogue for companies lies partly in the fact that it is important to retain investors and secure their capital for future projects (Watts and Zimmerman, 1986 and Marston, 1999). Maintaining good relations through dialogue between management and investors is also important in securing the loyalty of investors to the company in the face of a hostile takeover bid (Barker, 1998). Furthermore, Holland (1997/1998), argues that corporate communication decision policies are driven by strategy and corporate financing policies. The importance of dialogue between institutional investors and their agents with management was also emphasised by Higgs (2003) and Myners (2001) Reports.

Legal scholars such as Black (1994) and Coffee (1991) have also speculated on the willingness of institutional investors in keeping a ‘cosy’ relationship to maintain the flow of soft information that corporate managers provide to ‘friendly’ shareholders. In the UK, corporate managers can only provide soft information to shareholders in, as II 222 describes it, ‘non-central areas (e.g. SRI matters)’ (see Al-Hawamdeh and Snaith, 2005). This is because, corporate managers may otherwise be considered in breach of the Listing Rules if they disclose any price sensitive information before it is made public. Monitoring needs information (Al-Hawamdeh and Snaith, 2005). However, published information as required by the Listing Rules Continuing Obligations is thought to be limited in the information it offers. Hence, soft information might indeed be needed to clarify a public announcement, for example.

The fact that there is tight regulatory control on how and what information could be disseminated by companies to their institutional shareholders and investment mangers (Al-Hawamdeh and Snaith, 2005) could provide an explanation to why a clear majority of 57.1% of investment managers (Table 8) did not believe that keeping access to soft information through friendly relations with corporate managers is a reason for inactive monitoring of corporate performance. However, 35.7% still thought it was a reason. A lower percentage of institutional investors (18.6%) believed that keeping access to soft information is a deterrent on monitoring, whilst 47.1% did not.

3.8. Conflict of Interests

It might be argued that institutional investors generally, but particularly insurance companies and banks, could be '[…] shy of in criticising PLC's who give their company work' (II 359). On the other hand, there are '[u]sually arms length relationships between [an] investment manager subsidiary and [its] parent' (II 227). At least in theory, '[…] companies will seek to keep the two sides separate and judge each on its merits' (II 38). The concern here however, is whether institutional investors and investment managers perceive a conflict of interests as a reason that might affect monitoring corporations and their managers. Table 9 shows that around half of the respondents from both groups did not think that a conflict of interests is a reason for shareholders' inactivity in monitoring company managers. 35.7% of investment managers and 30.4% of institutional investors believed it to be a reason. The figures 35.7% and 30.4% are rather significant. This is because at least in theory, a conflict of interests should not exist because of the application of the 'Chinese Walls' method and the legal and moral responsibility of institutional investors and investment managers to act in the best interests of their trustees and beneficiaries.

3.9. Short Termism

The definition of short termism is well debated. Yet, for the purpose of this paper, short termism is defined as being the opposite of 'long termism'. Long termism is viewed as that which encompasses investors' commitments to buy and hold reasonably significant blocks of a corporation's shares. Hence, short termism occurs when an investor is not committed to holding acquired shares. This definition brings about the 'relational investment' debate, which simply means that in order for shareholders to be active in monitoring management they must have the commitment to buy a significant holding in a corporation (Ayres and Gramton, 1994, p.1033). Indeed, the particular importance of long term investors to corporate managers is that such an investor would be committed not to tender shares during a hostile takeover (Ayres and Gramton, 1994, p.1034).

As for short term investors, one could easily envisage that monitoring corporations and their managers would not benefit them. This is because most of the benefits brought about by monitoring corporations and their managers would be reaped in the long term. A short term shareholder might not perceive monitoring and intervening in corporate governance issues, such as electing new independent directors (non-executive directors), as beneficial to them, since the option of exit is largely available to shareholders in a corporation. In fact, it could be argued that short term investors may perceive monitoring and being active, as a creator of bad publicity, which could negatively affect share price and limit the option of exit.

Corporate governance in some cases also causes investors to take a long or short term view in holding investment in a company. Hence, investors might sometimes be forced to take a short term view when they find themselves

helpless to change the company for the better. Some institutional investors might not intend to be short term investors but business needs related to raising money might push them to sell shares in certain companies in a shorter time span than originally planned. For instance, II 3 argued that:

> Only if they are not interested in the investment at all and looking for a "quick gain" – even so I would have thought that good practice implies looking at corporate managers' performance.

Table 10 shows that investment managers were equally divided (50:50) on whether short termism is a reason for inactivity. 44.1% of institutional investors believed however, that it is a reason, whilst 39.2% believed that it is not. The evenly divided distribution of those respondents who agreed and disagreed probably reflects the fact that there is no agreement on the meaning of short termism.

3.10. Management Manipulation of the General Meeting Agenda

The company voting system in the UK gives corporate managers the advantage, which might allow them to manipulate the general meeting agenda. Corporate managers for example, would have the advantage of examining a statement put forward by shareholders proposing a resolution, and prepare to defeat it. Their position further allows them to spin facts in relation to their own proposed resolutions in order to defeat resolutions suggested by other shareholders. Moreover, other investors would usually trust management, rather than unknown shareholders initiating a protest.

The responses from both groups were very similar. Table 11 suggests that a small minority of less that 15% of both groups thought corporate managers' manipulation of the general meeting agenda is a reason for investors' apathy in monitoring corporations and their managers. A majority of 55.9% of institutional investors and a large majority of 78.6% of investment managers believed that it is not a reason. One institutional investor (II 146) thought that such an, 'attempt to manipulate the agenda would be too transparent and obvious and therefore institutional investors would stop it.'

Another institutional investor commented (II 587): '[s]hareholders can put resolutions if feeling particularly aggrieved. Also many discussions go on behind the seen – no vote.' This comment confirms some commentators' suggestions that dialogue between investors and corporate managers takes place behind the scenes. However, the latter comment suggests that voting and general meeting resolutions are not very relevant as a tool for monitoring and controlling corporations and their managers. This is surprising. In fact, a number of institutional investors and investment managers stated bluntly that the general meeting is irrelevant. II 634 said 'Annual general meeting is usually an irrelevant piece of legally required window dressing'. Another investor thought that '[i]nvestors should address issues outside Annual general meeting' (II 227).

3.11. Political Retaliation

Legal scholars such as Roe have written about political retaliation as a reason that might negatively affect investors' monitoring and control of corporations and their managers[5]. The case that is usually stated in this context is the Glass-Steagall Act[6] in the US, which limited investors' powers by not allowing banks to exceed a certain threshold when holding shares in companies. In the UK however, political retaliation is not thought to be an issue. If anything, it is believed that the UK Government actually encourages the interference of institutional investors in corporate governance. For example, the UK Government supports shareholder participation in corporate governance issues such as executive pay and taking a longer term view in decision making.[7]

The UK Financial Services Authority's announcement that it would not tolerate 'selective briefing' is different from political retaliation (Al-Hawamdeh and Snaith, 2005). This is because it does not object to investors' involvement in corporate governance. It is rather based on treating all shareholders equally. As political retaliation is not thought to be an issue in the UK, it is not surprising as Table 12 shows that approximately three quarters of both groups thought political retaliation was not a reason for investors' apathy in monitoring corporate managers. In fact, a negligible 2.9% of institutional investors thought political retaliation was a cause for inactivity. A higher percentage of investment managers (14.3%) thought that it is not a cause.

3.12. Investing in Index Funds and the Investors' Ability to Influence Corporate Governance

Indexing is a very popular form of investment among institutional investors. 46.5% of the institutional investors who responded to the questionnaire invest in index funds. However, there is great concern about the effect of this method of investment when it comes to corporate governance issues. The problem with indexing is that it does not give the legal owner of shares the power to be involved in monitoring corporations and their managers. For example, it does not give the legal owners the right to attend or vote in the general meeting. Hence, indexing no doubt affects the issue of monitoring of corporations and their managers.

As Table 13 demonstrates, the majority of over 58.8% of institutional investors and a majority of 57.1% of investment managers thought that investing in index funds, rather than directly in shares, negatively affects investors' ability to influence corporate governance. On the other hand, 24.5% of institutional investors and 35.7% of investment managers thought that it does not affect investors' ability. Although a clear majority in both groups (as illustrated in Table 13), thought investing in index funds is a reason, this was surprising. The initial expectation was that a higher percentage would agree that index fund investment is a reason. Nonetheless,

strong views were expressed that indexing is an issue that needs to be regulated to give legal owners powers to be involved in corporate governance. For example, II 343, said: 'Index fund must be required to vote.'

Some comments reveal the reason for the lower percentage than initially expected. Seven institutional investors and one investment manager for example, stated that indexing is an incentive for engaging shareholders more in corporate governance issues. Indexing can be an incentive to monitor corporations and their managers as shareholders are locked in, indirectly to particular companies, especially those representing a high proportion of the whole market, since shareholders are unable to sell the shares. However, the problem is that the constitutional machinery of the companies in the UK does not give those who own an investment through an index fund the right to interfere directly with corporate governance issues. Rather, it is done indirectly and through the managers of the index.

3.13. Other Reasons that Affect Shareholders' Willingness to Monitor Corporate Managers

Both institutional investors and investment managers were asked whether they believed there were any other reasons, (not already mentioned in the questionnaire) for the inactive monitoring of corporate managers by shareholders, and what these reasons were. Thirteen institutional investors and three investment managers provided reasons for apathy other than those mentioned in the questionnaire. The most popular reason provided (four institutional investors and one investment manager) was lack of resources; i.e. time and people[8]. Another reason provided was a failure to realise the importance of monitoring in enhancing performance. This might be the basis for investors' belief that monitoring will not add any value to performance, as is the case when company performance is poor for reasons other than bad management. II 431 stated: '[f]ailure to realize the possibility of adding value to investment corporate managers.' II 105, also associated it to resources, stating:

> It may not be a priority i.e. corporate governance is one aspect of many when investing. All decisions / monitoring has to be balance of many aspects, some more important than governance issues.

Other reasons mentioned included: the limitation of internal control and procedures and compliance; habit '[d]ifficulty for foreign shareholders' who are increasingly significant for UK companies; the option to exit the company; the reliance on the movement of share price rather than monitoring corporate managers; and finally, a very interesting comment mentioned by one investment manager respondent, the '[l]ack of knowledge / experience in institutions.' This particular reason was mentioned and emphasised by the Myners Review (2001).

4. Conclusions

This paper examined the opinions of UK institutional investors and investment managers, in relation to the twelve reasons that allegedly affect investors' willingness to monitor and control corporate managers. Differences were found between the responses of both groups, in relation to those reasons. The reason for such differences might be due in part to the roles and hence, expectations that these two groups have. Collectively, the twelve provided reasons do generally appear to hinder investors' willingness to monitor and control corporate managers in the UK, and hence cause apathy. In saying so however, some investors might not be affected by these reasons. Other investors may indeed be affected by these reasons but are still willing to monitor corporate managers, in attempting to encourage good corporate governance practices.

The Institutional Shareholders' Committee Statement of Principles on the Responsibilities of Institutional Investors and Agents 2002, and its successive review in 2005 has in no doubt helped in outlining the best practice principles, in relation to institutional shareholders and/or agents to their responsibilities in respect of the companies they invest in. The problem though, is that the particular information reported, including the format in which details of how votes have been cast is a matter of agreement between agents and their principals/clients. Hence, the suggestion of the Confederation of British Industry (CBI), in introducing an investor code of best practice could lead to an increase in the engagement of institutional shareholders and investment managers with their investee companies (see, Tucker, p.1). In fact, what is needed is a voluntary code of best practice; following on from the footsteps of the 'company code of best practice', in which listed companies currently have to either comply with its principles or justify why they have chosen not to do so. Influential institutions such as the National Association of Pension Funds (NAPF hereafter) and the Association of British Insurers (ABI hereafter) could indeed play a great part in ensuring that such a code is successful. Hence, it is surprising that there is some resistance among institutional investors to adopt such a code. Furthermore, it is essential that an independent body like the Financial Services Authority enforces such a code.

Such a code could indeed increase institutional investors' and investment managers' transparency and therefore accountability to their clients and beneficiaries. The code should also take into account principles to avoid reasons for apathy, such as those mentioned above. Such principles should ensure that institutional investors monitor and hold corporate managers to account when performing their duties, in order to achieve a sounder corporate governance system.

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1 [1989] BCLC 100.

2 It is alleged that the primary safeguard for shareholders in listed companies is supposedly, the ability to sell their shares. This is based on the assumption that the market is perfect. However, in a perfect market, the stock market should ideally operate as a daily plebiscite; enabling every single shareholder, regardless of size, to 'register' his or her individual reaction to what goes on in a corporation. Hence, the assumption is that shareholders would then be able to 'register' their concerns without having to be either a majority or build coalitions, in order to be able to win a vote in the general meeting. Yet, this is a mere myth in an imperfect market. See, H. Manne, 'Mergers and the Market for Corporate Control', (1965) 73, Journal of Political Economy, 110; see also, R. Hessen, 'A New Concept of Corporations: A Contractual and Private Property Model', (1979) 30, The Hastings Law Journal, 1327, at 1345-1346.

3 A list of all outside investment managers used by members of the NAPF and the ABI was requested from both the NAPF and ABI's membership lists. This was received in October 2000.

4 Response rates were calculated as follow: Response rate = number of responses (total responses – (ineligible4 + unreachable4)) divided by (total number in sample – (total of ineligible + unreachable)).

Institutional investors sample: the total number of returns was 231, where 77 refused to co-operate, 39 were classified as ineligible (do not invest in LSE), 13 classified as unreachable (no longer in address). The response rate was 13.82% (102/738[867-39-77-13]).

Investment managers sample: the total number of returns was 36, where 15 refused to co-operate, 5 were classified as ineligible (do not invest in LSE), 2 classified as unreachable (no longer in address). The response rate was 12.72% (14/110[136-2-5-15]).

[5] The 'political' theory of corporate governance argues that institutions are regulated into submission by legal rules which, deliberately or not, 'hobble' them and raise the cost of participation in corporate governance. See, B. Black, 'Shareholder Passivity Re-examined', (1990) 89, Michigan Law Review, 575; and, M. Roe, 'Chaos and Evolution in Law and Economics', (1996), 109, Harvard Law Review, 643.
Mark Roe has written extensively on political theory and state hindrance to institutional investors' interference in corporate governance

6 The Glass-Steagall Act prohibited combining commercial and investment banking; federal securities rules, chilling institutional investors' group formation. See, B. Black and J. Coffee, 'Hail Britannia?: Institutional Investor Behavior Under Limited Regulation', (1998) 92, Michigan Law Review, 1997, at 1999.

7 The DTI publications, including parts of the Company Law Review

8 The comments are as follows:

Institutional investors' questionnaire, control number 418: 'It's very time consuming and the pay back is not enough.'

Institutional investors' questionnaire, control number 343: 'In my case, inadequate in the investment department (of one person!).'

Institutional investors' questionnaire, control number 38: 'Lack of time. Everyone is working flat out and inevitably some things have to be dealt with superficially rather than in depth.'

Institutional investors' questionnaire, control number 100: 'Organizations must have a very significant resource to effectively monitor all companies and this is costly.'