

# Financial Economists Roundtable

## Statement on Institutional Investors and Corporate Governance

December 1, 1998

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### Implications of Increased Institutional Ownership of Common Stock

Common stock ownership in the United States has increasingly passed into the hands of financial institutions. It is estimated that institutional ownership of public corporations' common stock grew from 6 percent of the total in 1950 to 47 percent by the end of 1996. Institutions now hold nearly 60 percent of the stock of the 1,000 largest U.S. corporations, and they collectively hold more than 50 percent of the stock in two-thirds of these corporations. In only 12.5 percent of these same corporations do institutional holdings account for less than 30 percent.

The increase in institutional holdings clearly creates the potential for financial institutions to play a greater role in corporate governance. Some, arguing from the American populist political tradition, see this as a potentially dangerous aggregation of power in the hands of concentrated financial interests. The Financial Economists Roundtable views increased institutional ownership of common stock as a favorable development because because of its potential for mitigating the problems associated with the separation of ownership from control in large corporations.

Shareholder ownership carries with it voting rights, but in public corporations such voting rights provide a less effective mechanism for oversight of management the more diffuse ownership becomes. As recognized by Adolph Berle and Gardiner Means more than sixty years ago, the resulting separation of ownership from control can afford management the latitude to entrench itself and to pursue objectives that may be inconsistent with shareholders' best interests. Increased institutional stock ownership has the potential to overcome problems that can render ineffective the oversight exerted by individual shareholders. First, the larger the ownership position held by any one entity, the greater is its incentive to oversee management actively. Because larger owners more fully capture the economic benefits stemming from their activism, they are more likely to perceive oversight activities as cost effective. Second, larger ownership positions can reduce the costs of coordinating management oversight activities with other owners. Third, as institutional ownership positions become larger, institutions may find it more difficult and costly to sell their positions in large blocks of shares of companies in which they feel managers are not maximizing shareholder value.

The Financial Economists Roundtable recognizes that institutional ownership poses its own incentive conflicts, since the ownership of stock in institutional portfolios is separated from the management of those portfolios. Institutional portfolio managers represent their shareholders or beneficiaries. It is important that they pursue objectives that are consistent with the interests of such shareholders or beneficiaries.

### **The Appropriate Role for Institutions in Corporate Governance**

The Roundtable encourages institutional owners to take a proactive role in corporate governance. Specifically, the institutions we are referring to include mutual funds, bank trust departments, defined contribution pension funds, and variable annuities. By taking a proactive role, the Financial Economists Roundtable means: (1) thoughtfully and responsibly voting their shares, (2) communicating with management, the press, and, to the extent allowed by law, other shareholders and (3) introducing proxy resolutions.

### **The Objective of Institutional Participation in Corporate Governance**

The primary objective of institutional participation in corporate governance should be to maximize economic value for the institutions' shareholders and beneficiaries. Institutional shareowners should pursue governance initiatives that will maximize the market value of their portfolios. They should not pursue initiatives intended to further the interests of other corporate stakeholders, such as suppliers, customers or employees, to the detriment of shareholders. This also excludes the pursuit of social or political objectives that will not be economically beneficial to shareholders.

While we strongly encourage institutional owners to be governed by the general principle of enhancing economic value, we recognize that in some cases institutions and their beneficiaries will wish to pursue noneconomic objectives. These might stem from shared religious beliefs, as in the case of a retirement fund managed on behalf of a religious order. In other cases, a majority of beneficiaries may wish to see their fund invested so as to promote such goals as social equality or environmental improvement.

The pursuit of these alternative goals should be constrained by two conditions. First, any noneconomic objective should be clearly and fully disclosed to all shareholders and beneficiaries. Second, with the possible exception of funds managed for religious groups (in which membership is voluntary and based on shared noneconomic values), a viable alternative should be made available to any shareholder or beneficiary who does not wish to participate in the pursuit of a noneconomic objective. Such an alternative could consist of the right to withdraw one's funds entirely and without penalty, as in the case of open-end mutual funds. The availability of an alternative investment fund that pursues only value maximization would also satisfy this requirement. We believe that the burden should be on institutional fund managers to show that viable alternative investment opportunities exist for shareholders and beneficiaries.

### **Public Policy Issues**

It should be a public policy objective to make corporate governance by institutional owners as effective as possible. The Roundtable therefore opposes any legal or regulatory constraints on the ability of fund managers to vote or communicate with management of

portfolio companies. The Financial Economists Roundtable also urges a thorough legislative review of existing restrictions on institutional ownership positions and other legal impediments to effective governance by institutional owners. The review would seek to determine what changes might either reduce the costs associated with institutions' exercise of ownership powers or increase the incentives of institutional fund managers to take an active role in corporate governance.

### **Conclusions**

Institutional stock ownership has grown steadily in the post-World War II period, and financial institutions are now major shareholders in U.S. corporations.

- Increased institutional ownership of common stock has the potential to increase the effectiveness of corporate governance and to mitigate the problems created by the separation of ownership from control in large corporations.
  - Financial institutions should take a proactive role in corporate governance.
  - The primary objective in institutions taking this role should be the maximization of economic value for the institution's shareholders or beneficiaries.
  - Financial institutions that pursue noneconomic objectives in their governance initiatives should meet two tests: (1) such objectives have been clearly and fully disclosed to shareholders and beneficiaries and (2) shareholders and beneficiaries have a viable alternative investment strategy made available to them.
  - The Financial Economists Roundtable urges a review of existing restrictions on institutional ownership and other legal impediments to the institutions' effective exercise of ownership rights.
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# **FER Members Signing Statement**

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