Corporate Governance, Corporate Ownership, and the Role of Institutional Investors: A Global Perspective

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We examine the relation between corporate governance and ownership structure, focusing on the role of institutional investors. In many countries, institutional investors have become dominant players in the financial markets. We discuss the theoretical basis for, history of, and empirical evidence on institutional investor involvement in shareholder monitoring. We examine cross-country differences in ownership structures and the implications of these differences for institutional investor involvement in corporate governance. Although there may be some convergence in governance practices across countries over time, the endogenous nature of the interrelation among governance factors suggests that variation in governance structures will persist. [G30, G34]

■The need for corporate governance arises from the potential conflicts of interest among participants (stakeholders) in the corporate structure. These conflicts of interest, often referred to as agency problems, arise from two main sources. First, different participants have different goals and preferences. Second, the participants have imperfect information as to each others' actions, knowledge, and preferences. Berle and Means (1932) address these conflicts by examining the separation of corporate ownership from corporate management—commonly referred to as the separation of ownership and control. They note that this separation, absent other corporate governance mechanisms, provides executives with the ability to act in their own self-interest rather than in the interests of shareholders.[1]

However, executives' activities are potentially constrained by numerous factors that constitute and influence the governance of the corporations that they manage. These factors include the board of directors (who have the right to hire, fire, and compensate managers), financing agreements, laws and regulations, labor contracts, the market for corporate control, and even the competitive environment. In general terms, these factors can be thought of as either internal control mechanisms (such as the board) or external control mechanisms (such as the market for corporate control). An increasingly important external control mechanism affecting governance worldwide is the emergence of institutional investors as equity owners. Institutional investors have the potential to influence management's activities directly through their ownership, and indirectly by trading their shares. An institution's indirect influence can be quite strong. For instance, institutional investors may act as a group to avoid investing in a particular company, thereby increasing that company's cost of capital. In this paper we consider the role of institutional investors in corporate governance, the motivation for that role, and how the role has changed during the recent past.[2]

Before assessing the role of institutional investors in corporate governance, we must first define what

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[1]For more recent discussions see Fama and Jensen (1983), Jensen and Meckling (1976), and Jensen (1993).

[2]For recent reviews of other governance issues, see Brunt, Bolton, and Roell (2003), Denis (2001), Denis and McConnell (2003), and Holmstrom and Kaplan (2001, 2003).

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

As the corporate environment has changed, so too have corporate governance practices. Governance changes, although differing by country, have been particularly common in economies where the banking, capital markets, and legal systems have undergone dramatic change.[3] Governance changes have also been prevalent in countries with relatively high levels of institutional investment. Indeed, we argue that institutional investors, often foreign institutional investors, play a central role in prompting change in many corporate governance systems. We recognize that changes in corporate governance, including ownership structures and the role of institutional investors, are likely to arise as endogenous responses to environmental factors. For example, there is evidence to suggest that corporate governance and investor protections are stronger in common law, as opposed to civil law, countries. Thus, although institutional investors may drive corporate governance changes and financial liberalization in some economies, in others institutional ownership will change in response to governmental actions and changes in the regulatory environment.

In Section I, we discuss why large shareholders and institutional investors monitor managers. Section II reviews the history of institutional ownership and activism and the efficacy of such activism. We also discuss how the legal environment can affect a company's governance and ownership structure. In Section III, we focus on the implications of different ownership structures for corporate governance. We also consider how different owners might interact, thus affecting the role of institutional investors. After a brief discussion of the role of foreign institutional investor. We conclude the article in Section IV.

I. Rationale for Institutional Investor Involvement in Corporate Governance

In many countries, institutional investors became a significant, if not majority, component of equity markets during the latter half of the twentieth century. For example, in the United States (US), institutional investment grew from 6.1% of aggregate ownership of equities in 1950 to over 50% by 2002 (Board of Governors of the Federal Reserve System, 2003). Assets held by institutional investors have also grown in other markets. For example, total financial assets held by institutions in the European Union grew more than 150% between 1992 and 1999 (Conference Board, 2002). Although institutional investors have not played as prominent a role in emerging markets, pension reform and privatization initiatives have started to influence the financial holdings of institutions, and thus the capital markets in these economies as well. For example, domestic pension funds are now the most important minority shareholders in Chilean publicly traded companies. They are also a major source of debt financing to these companies (Iglesias-Palau, 2000; Lefort and Walker, 2000a). Given the differences in institutional ownership across markets, we consider the role of institutional shareholder monitoring in economies characterized by diffuse ownership and in economies characterized by dominant controlling shareholders.

The appropriate role for institutional shareholders in any economy is the subject of continuing debate. Shareholders, as the owners of the firm, have certain rights, including the right to elect the Board of Directors. The Board, as the agent of the shareholders, has the responsibility to monitor corporate managers and their performance. If shareholders such as institutional investors become dissatisfied with the Board's performance (and presumably that of the firm), they have three choices: 1) 'vote with their feet,' i.e., sell their shares; 2) hold their shares and voice their dissatisfaction, or 3) hold their shares and do nothing. Hirschman (1971) has characterized these alternatives as: exit, voice, and loyalty. The question naturally arises: what conditions lead investors to exercise their voice, i.e., engage in monitoring, as opposed to remaining loyal or simply exiting?

A. The Institutional Investor as Monitor

It is not just the separation of ownership and control that gives rise to the agency problem between shareholders and managers, it is also the atomistic or diffuse nature of corporate ownership, which is

[3]For analyses of corporate governance provisions across industries and firms in the United States, see, for example, Danielson and Karpoff (1998) and Gillan, Hartzell, and Starks (2003).

characterized by a large number of small shareholders (Roe, 1990). In a highly diffuse ownership structure, there is no incentive for any one owner to monitor corporate management, because the individual owner would bear the entire monitoring costs, yet all shareholders would enjoy the benefits. Thus, both the magnitude and nature of agency problems are directly related to ownership structures. Given the variation in ownership structures around the world, one would also expect variations in the form, consequences, and solutions to the shareholder-manager agency problem. In countries where ownership structures are dominated by large shareholders, agency problems caused by the separation of ownership and control may not be prevalent.

Indeed, many authors argue that the involvement of large shareholders in monitoring or control activities has the potential to limit agency problems (Shleifer and Vishny, 1986; Admati, Pfleiderer, and Zechner, 1993; Huddart, 1993; Maug, 1998; and Noe, 2002). These authors have further argued that, because all shareholders benefit from the actions of a monitoring shareholder without incurring the costs, only large shareholders have sufficient incentives to monitor.[4]

Empirical evidence on the monitoring role played by large shareholders has provided some support for this theory. For example, Bethel, Liebeskind, and Opler (1998) report that company performance improves after an activist investor purchases a block of shares. Kang and Shivdasani (1995) and Kaplan and Minton (1994) find that the presence of large shareholders is associated with increased management turnover, suggesting that these shareholders provide a monitoring function. Moreover, Bertrand and Mullainathan (2001) find that the presence of a large shareholder on the board is associated with tighter control over executive compensation.

A different perspective arises when the large shareholder is also a lending institution. Previous research argues that lenders occupy a unique governance position given their monitoring and control abilities. In particular, the argument has been made that banks have a comparative advantage in monitoring corporations due to their access to inside information. The bank lenders' access to superior information, relative to the information available to bondholders, reduces potential agency costs of debt financing (Fama, 1985). Studies of countries that restrict investment by lending institutions provide empirical evidence to support this view. For example, in the US, for most of the twentieth century, legislation prohibited banks from holding equity in a firm. In Japan, however, banks could take large equity positions in firms, including firms to which they made loans. Theoretically, if institutions who are equity holders and lenders to the same firm are more effective monitors, then agency problems in Japan should be less than those in the US, everything else equal.

The evidence on the role of lenders in the Japanese equity markets is mixed. Prowse (1990) and Kaplan and Minton (1994) conclude that banks are an important aspect of corporate governance in Japan. More recent research, however, has questioned the effectiveness of banks in governing corporations. Morck and Nakamura (1999) argue that bank intervention serves the short-term interests of the bank rather than the interests of the firms' shareholders. Moreover, Kang and Stulz (2000) report that, during the 1990s, bank-dependent Japanese firms experienced worse stock price performance than other firms.[5] In Germany, Boehmer (1999) reports that banks control a substantially higher fraction of corporate voting rights than cash-flow rights (due to board memberships and control of proxy votes). Since banks typically have larger loan positions than equity investments in portfolio companies, it is unclear whether banks' voting power is used in the shareholders' interests. Indeed, Boehmer provides empirical evidence that bank control appears to have only a modest association with a portfolio company's stock market performance. Similarly, Franks and Mayer (1998) report that the role of banks in several hostile takeovers in Germany indicates that they did not act in shareholders' interests.

The evidence from studies comparing corporate governance structures and their effects should be interpreted with caution. For example, the observed differences in bank equity holdings among Germany, Japan, and the US did not arise in isolation, and might be related to other differences in these countries' corporate governance structures.[6] Moreover, institutions with debt and equity interests in portfolio companies might have different goals from other types of shareholders. Thus, as the papers discussed above suggest, it is not clear that lender equity positions would uniformly benefit corporate governance and firm performance.

[4]That is, the existence of a large shareholder can provide a partial solution to the free-rider problem inherent in diffusely owned companies (Grossman and Hart, 1980). As pointed out by Shleifer and Vishny (1986), however, because the large shareholder can only reap the gains to his or her own shares, even the existence of such a monitoring shareholder will still lead to too little monitoring.

[5]See Andersen and Campbell (2002) for a more detailed discussion of Japanese bank governance.

[6]There is also the issue of variations in corporate governance structures across industries (e.g., Gillan, Hartzell, and Starks, 2003). If there are industries that differ across these countries, then deviations arising from differences in industries could be mistakenly attributed to differences in countries. For example, Macey and O'Hara (2001) argue that the uniqueness of the banking industry requires different corporate governance structures from other industries.

B. Institutional Investors, Monitoring, and Information Transmission: Theory and Evidence

Another potential role for large institutional investors is to provide a credible mechanism for transmitting information to the financial markets, that is, to other investors. According to Chidambaran and John (2000), large institutional investors can convey private information that they obtain from management to other shareholders. But for such monitoring to be credible, the large shareholder would need to maintain the investment for a sufficiently long period of time and hold enough shares to mitigate the free-rider problem. The result is that, under certain conditions, there will be a payoff for the institutional investor who performs costly monitoring to oversee managers, and a payoff for the manager who cooperates. Thus, Chidambaran and John (2000) argue that this type of monitoring, which can be termed 'relationship investing,' is optimal for both the large investor and management. On the other hand, Shleifer and Vishny (1986) envision a large shareholder who is willing to take control of the firm.

Differences exist between the monitoring abilities and incentives of institutional investors and those of large non-institutional blockholders. Gorton and Kahl (1999) argue that institutional investors might be imperfect monitors due to their own internal agency problems. But because there are not enough individual large blockholders to provide better monitoring, even the imperfect monitoring provided by the institutional investor is welcomed by shareholders. Thus, in the Gorton and Kahl model, large institutional investors and large non-institutional blockholders coexist as monitors of firms.

Empirical evidence on whether institutional investors do indeed provide effective monitoring is somewhat mixed. For example, Hartzell and Starks (2003) provide empirical evidence suggesting that institutional investors serve a monitoring role with regard to executive compensation contracts. First, they find a positive association between institutional ownership concentration and the pay-for-performance sensitivity of a firm's executive compensation. Second, they report a negative association between institutional ownership concentration and excess salary. One implication of these results, consistent with the theoretical literature regarding the role of the large shareholder, is that institutions have greater influence when they have larger proportional stakes in firms. Similarly, Chung, Firth, and Kim (2002) hypothesize that there will be less opportunistic earnings management in firms with more institutional investor ownership because the institutions will either put pressure on the firms to adopt better accounting policies, or they will be able to unravel the earnings management ruse so it will not benefit the managers. As expected, they find that when institutional investors own a large percentage of a firm's outstanding shares, there is less opportunistic earnings management (i.e., less use of discretionary accruals). In contrast, Renneboog (2000) finds no evidence of a monitoring role by institutional investors in the Belgian stock exchange.

Several studies examine the relation between a firm's aggregate institutional ownership and its R&D investment to see if institutional ownership affects managerial behavior, but these studies arrive at mixed conclusions. Based on his finding that the larger institutional ownership is associated with higher levels of R&D expenses, Bushee (1998) suggests that institutions in aggregate reduce the pressure that compels managers to behave myopically, although monitoring strength varies with the type of institutional investor. Notably, institutions characterized by high turnover and momentum trading appear to encourage myopic behavior in managers. But Wahal and McConnell (2000) reach a different conclusion when studying expenditures on R&D and property, plant, and equipment. They argue that regardless of the investment style, there is no evidence that institutional investors contribute to managerial myopia. Bange and DeBondt (1998) find that there is less earnings management (related to research and development) when institutional investors own a larger share of the firm.

Others also suggest that institutions play an important monitoring role. Agrawal and Mandelker (1990) find that firms with greater institutional ownership have larger stock price reactions upon the announcement of anti-takeover amendment adoption. Grier and Zychowicz (1994) find an inverse relation between institutional investor ownership and corporate leverage, and suggest that the two potential monitoring mechanisms play substitute roles. In contrast, Duggal and Millar (1999) conclude that active institutional investors do not play a significant monitoring role in the takeover market in that they find no association between institutional ownership and gains to bidders.

The incentive to monitor, and the effectiveness of monitoring, varies within the institutional investor community. For example, Pound (1988) argues that institutional investors have a tendency to help entrenched management by voting with the management team. Brickley, Lease, and Smith (1988) differentiate between the different types of institutional investors, noting the difference between pressure-sensitive and pressure-insensitive institutional shareholders and arguing that pressure-sensitive institutions are more likely to "go along" with management decisions. The rationale is that pressure-sensitive investors might have current or potential

business relations with the firm that they do not want to jeopardize.[7] The authors find evidence supporting their hypothesis—firms with greater holdings by pressure-sensitive shareholders (banks and insurance companies) have more proxy votes cast in favor of management's recommendations. Moreover, firms with greater holdings by pressure-insensitive shareholders (pension funds and mutual funds) have more proxy votes against management's recommendations.

Payne, Millar, and Glezen (1996) focus on banks as one type of institutional investor that would be expected to have business relations with firms in which they invest. They examine interlocking directorships and income-related relationships, and find when such relations exist, banks tend to vote in favor of management anti-takeover amendment proposals. When such relations do not exist, banks tend to vote against the management proposals. Van Nuys (1993) provides more direct evidence by examining institutional shareholder voting during a proxy battle at Honeywell.[8] Consistent with the Brickley et al. (1988) hypothesis, she found that banks and insurance companies were more supportive of management than other types of institutional investors. However, when she separated these institutions into those with known business ties to Honeywell and others, she found no significant difference in the voting behavior between the two groups.

Borokhovich, Brunarski, and Parrino (2000) adopt a different approach and examine the market reaction to news of an antitakeover measure conditioned on the identity of outside institutional blockholders. When the blockholders are individuals or pressure-insensitive institutions (investment companies or independent investment advisers), the market reaction and percentage blockholdings are positively related. When the blockholders are pressure-sensitive institutions, such as banks or insurance companies, market reaction and percentage blockholdings are negatively related.[9] This evidence further supports the Brickley et al. (1988) hypothesis.

Almazan, Hartzell, and Starks (2003) provide theoretical and empirical evidence that the monitoring influence of institutional investors on executive compensation can depend on the current or prospective business relation between the institution and the corporation. They find that the monitoring influence of institutions is associated more with potentially active institutions (investment companies and pension fund managers who would be less sensitive to pressure from corporate management due to lack of potential business relations) than with potentially passive institutions (banks and insurance companies who would be more pressure-sensitive).

Even investors that sell their shares rather than trying to instigate change in the firm can affect corporate governance. As noted by Parrino, Sias, and Starks (2003), there are several potential effects when institutions sell shares. First, heavy institutional selling can put downward pressure on the stock price (e.g., Brown and Brooke, 1993). Alternatively, institutional selling might be interpreted as bad news, thus triggering sales by other investors and further depressing the stock price. Finally, the composition of the shareholder base might change, for example, from institutional investors with a long-term focus to investors with a more myopic view. This last effect might be important to directors if the types of institutions holding the stock affect share value or the management of the company.

Parrino et al. (2003) find that those firms that fired their top executives had a significantly greater decline in institutional ownership in the year prior to the CEO turnover than firms experiencing voluntary CEO turnover (even after controlling for differences in performance). These results support the hypothesis that institutional selling influences decisions by the board of directors—increasing the likelihood a CEO is forced from office.[10] The implication is that boards care about institutional ownership and trading activity in their firms. Further, the authors find that larger decreases in institutional ownership are associated with a higher probability of an outsider being appointed to succeed the CEO. This result suggests that directors are more willing to break with the current corporate management and institute change in the face of external pressure.

Although a large institutional shareholder could receive benefits from monitoring, it could also bear costs. For example, concentrated ownership could reduce the level of trading activity or affect the price at which shares are sold, thus reducing market liquidity and adversely affecting the ability of the investors to sell their shares (Holmstrom and Tirole, 1993). This link between liquidity and monitoring (or control) has been addressed by several studies, including Coffee

[7]For example, an insurance company that underwrites for a corporate client may feel pressure to vote with corporate management or face losing the insurance business.

[8]In most studies of institutional voting behavior, the voting is inferred from relative ownership across different types of institutions. In this case, Van Nuys (1993) had information that identified the voting behavior of the particular institutions.

[9]Borokhovich et al. (2000) use the terms affiliated and unaffiliated rather than pressure-sensitive and pressure-insensitive.

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

(1991), Bhide (1994), Maug (1998), and Kahn and Winton (1998). One view is that liquidity and control are antithetical (Coffee, 1991; and Bhide, 1994). Historically, institutional investors have preferred liquidity to control because the ability to exercise control over corporate management entails a sacrifice of liquidity—an unacceptable cost to many institutional investors (Coffee, 1991). For example, in the US, while extensive regulation has promoted liquidity, it has also promoted diffuse, arm's length stock holding (Bhide, 1994). This, in turn, has discouraged owners and managers from establishing close relationships. There may be a reluctance on the part of money managers and corporate managers to exchange private information, because such information could compromise their positions. Put another way, insider trading and disclosure rules that enhance liquidity for passive shareholders can adversely affect governance by limiting monitoring by active shareholders.

The Securities and Exchange Commission has further reinforced this perspective by issuing new disclosure regulations ("Regulation Fair Disclosure.") In addition, institutional investors tend to stay below 10% ownership lest they trigger federal regulations pertaining to short-term and insider trading. Bhide (1994) also suggests that diversification rules in the US have led to institutional investors holding only small amounts of any one firm, which in turn compounds the free-rider problem. As such, many of those shareholders that could play an active role in the governance of the corporation instead remain passive.

Bhide's view contrasts with the more recent work of Maug (1998), Kahn and Winton (1998), and Noe (2002). Maug argues that the alleged trade-off between liquidity and control does not exist. Liquid markets in which shares can be traded easily without adverse price effects make it less costly to sell a large stake, but make it easier for investors to accumulate large stakes and to capitalize on shareholder activism. He concludes that the impact of liquidity on corporate control is unambiguously positive.

Kahn and Winton (1998) study the firm characteristics that affect an institutional shareholder's decision to intervene in a corporation's decision-making process and what this implies for firm ownership structure. They show that institutions choose to intervene depending on the benefits they receive from the increasing value of their existing stake in the firm and the effects on their trading profits. Finally, Noe (2002) demonstrates that a core group of institutional investors can naturally develop with the goal of monitoring the corporation and preventing managers from engaging in opportunism. In his model a wide range of institutions exist, from small to large, not all of which will be motivated to monitor. Some will choose to be passive, but there is not a monotonic relation between size of shareholdings and incentives. Noe also shows that there is not a monotonic relation between concentration of institutional ownership and liquidity.

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

II. Institutional Investor Activism across Countries

Our discussion of institutional investor activism begins by focusing on activism in the US (Subsection A), its effectiveness (Subsection B), and then progresses to examine aspects of activism in the international environment (Subsection C). Our discussion concludes by examining how the legal environment can affect a company's governance and ownership structure (Subsection D).

A. The US Experience

Given the increasing presence of institutional investors in financial markets (Gompers and Metrick (2001), it is not surprising that they have become more active in their role as shareholders. Activism by institutional investors has been both private and public, with the public activism being perhaps most visible in the US.[11]

Regulation in the US has strongly influenced whether institutional investors adopt a policy of exit, voice, or loyalty. In the early 1900s, insurance companies, mutual funds, and banks became active in corporate governance (i.e., exercised voice). In all cases, however, laws were passed to limit the power of financial intermediaries and to prevent them from having an active role in corporate governance (Roe, 1990). In particular, banks were prohibited from owning equity directly, and this regulation has caused the corporate governance system in the US to differ historically from that in other countries such as Germany and Japan where, by design, institutions (particularly banks) have played a large role in the ownership and monitoring of corporations.

In recent years, US government agencies changed their position regarding institutional involvement in corporate ownership, control, and monitoring. For instance, the Labor Department now encourages pension funds to be active in monitoring and communicating with corporate management if such activities are likely to increase the value of the funds'

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

holdings.[12] In 1992 and 1997 decisions by the Securities and Exchange Commission allowed shareholders more flexibility in communicating with each other and submitting shareholder proposals. And, in 1999, Congress repealed the Glass-Stegall Act, ending restrictions on direct ownership of US equity by banks. More recently, in July 2003, the Securities and Exchange Commission proposed opening up the director nominations process to shareholders.

Despite the earlier legal and regulatory impediments, some US institutional investors became more active in corporate governance in the last two decades of the twentieth century. In the mid-1980s, for example, public pension and union funds started submitting shareholder proposals to companies, both individually and in collaboration with each other.[13] Later, they changed their strategy somewhat by negotiating directly with corporate management and by publicly targeting corporations through the media.

In addition to public pension funds, private pension and mutual fund advisors have become more involved in the corporate governance of firms in which they hold investments (although their activism has tended to be less publicized). For instance, some money managers have purportedly influenced high profile decisions to replace top managers (Myerson, 1993; and *Pensions and Investments*, 1993). Others, such as the Lens Fund and Relational Investors, have specifically targeted poorly performing companies with a perceived poor governance structure and actively pressured management for reform.

In a survey of 231 portfolio managers and institutional shareholders, 77% of the respondents had participated in some form of activism in the previous year, either by communicating their opinions directly to a board (verbally or by letter), seeking more involvement in board oversight, sponsoring a shareholder resolution, or voting in favor of a shareholder resolution (*Corporate Board*, 1997). According to Ettorre (1996), "Fifteen years ago, the CEO and CFO did not know major holders and really didn't care. CEOs are now more accessible to money managers." This attitude demonstrates the increasing importance of institutional investors.[14] In fact, since the corporate scandals of 2001 and 2002, institutional investors have tended to become more active. According to Brent (2002) more mutual funds are initiating shareholder proposals and voting proxies. He goes on to report that the investment community has viewed these activities favorably because the mutual funds may be able to restore some of the confidence lost by the scandals. For example, one fund manager encouraged other shareholders to take action with regard to perceived problems at Disney. In addition, Fidelity, the world's largest mutual fund manager, actually took control of a corporation by appointing one of its employees as chief executive of Colt Telecom (Phillips, 2002).

Although some institutional investors have been active, others have generally been reluctant to engage in activism against corporations in which they have equity stakes, perhaps in fear of retaliation. As pointed out previously, because of their current or potential business relations with the corporation, pressure-sensitive institutional investors might be compelled to vote with the management even if contrary to their fiduciary interests (Pound, 1988; and Brickley et al., 1988). Thus, there is a presumption that some institutional investors have a conflict of interest in monitoring management. However, Romano (1993) finds no evidence to support a widely held hypothesis that public pension funds are more effective monitors of management because they vote their own shares, in contrast to private pension funds that typically delegate their voting to external money managers. She cites a survey of institutional investors from the IRRC in which there is no significant difference in voting policy between public and private pension funds; both groups supported management over the survey period.

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

The efficacy and appropriateness of activism by institutional investors has been a matter of debate. Those in favor of institutional investor activism maintain that it results in improved corporate

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

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

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

governance and that it has positive externalities, because the monitoring benefits all shareholders. These advocates of activism also argue that institutional monitoring provides incentives for managers to focus on the firm's longer-term, rather than shorter-term, prospects, thus, counteracting tendencies toward managerial myopia.

In contrast, others contend that institutional investors should not have a role in corporate governance. For example, some argue that portfolio managers lack the expertise to advise corporate management. (This is essentially the same argument behind the passage of early twentieth century laws limiting control by institutional investors. The legislators did not want "Wall Street" directing "Main Street.") Opponents to institutional shareholder activism also maintain that the activism detracts from the primary role of pension funds, which is managing money for the beneficiaries. Further, Murphy and Van Nuys (1994) have questioned the incentives for public pension fund managers to undertake such activities. Indeed, these authors contend that the incentive structure of the public pension funds is such that it is rather surprising that we see them engaged in this activity at all. Woidtke (2002) tests this hypothesis by comparing the relative value of firms held for public versus private pension funds. She reports that relative firm value is positively related to private pension fund ownership and negatively related to (activist) public pension fund ownership. She believes these results support the view that the actions of public pension fund managers might be motivated more by political or social influences than by firm performance. Finally, Monks (1995) makes the point that public pension funds would more naturally serve as valuable allies for other active investors rather than as primary activists themselves.

B. Effectiveness of Institutional Investor Activism

Measuring the effectiveness of shareholder activism is problematic. First, it is difficult to determine the outcome of activism and whether it has had positive consequences for the firm. For example, after the submission of a shareholder proposal, we can explore whether changes in the firm's governance structure reflect the intentions of the activists. That is, do firms repeal their anti-takeover amendments, change their compensation plans, or change the structure of their board of directors after shareholder proposals are submitted?[15] But how do we know whether any changes that do occur have been caused by the activism and whether the changes have actually resulted in economic changes for the targeted firm? For example, one major goal of shareholder activists has been increased board independence. Although we can observe whether there are more independent directors, it is difficult to directly attribute the increase to shareholder activism. More importantly, it is difficult to assess whether changing the composition of the board in this way actually results in economic changes for the corporation.[16]

A second problem arises in that much of the activism is conducted "behind the scenes" through private negotiations where there is no external observation of the event. For example, the California Public Employees Retirement System (CalPERS) submitted a shareholder proposal to Texaco calling for the creation of an advisory committee of major shareholders to work with management. However, CalPERS negotiated directly with Texaco and reached an agreement that Texaco would nominate a pro-shareholder candidate to its board of directors. CalPERS then withdrew its shareholder proposal (Parker, 1989).[17] More recently, TIAA-CREF has pressured companies to remove "dead-hand" provisions from poison pill anti-takeover measures. The dead-hand provision allows only the directors who put the poison pill in place to remove it (for a set period after they have been replaced), thus potentially delaying a new board's decision to sell the company. Since 1998, when TIAA-CREF began its campaign to end dead-hand provisions, 56 of 60 corporations approached have removed them, or have removed their pills altogether.[18] Such activities have not been included in most studies of shareholder activism. An exception is a study by Carleton, Nelson, and Weisbach (1998) of direct negotiations between TIAA-CREF and targeted companies during the 1992-1996 period. The authors state that of the 45 firms contacted by TIAA-CREF to make changes in corporate governance, 71% reached a negotiated settlement prior to a vote on the shareholder proposal. The remaining 29% of the firms resisted TIAA-CREF's pressures and the shareholder proposals went to a vote. This suggests that academic studies might substantially understate the effects of shareholder activism because they do not observe the full set of

[15]Examples of studies that examine the relation between corporate governance and firm decision, firm value or firm performance include Bhagat and Black, 1998b; Bebchuk and Cohen, 2003; Carter, Simkins, Simpson, 2003; Garvey and Hanka, 1999; Gompers, Ishii, and Metrick, 2003, Johnson and Rao, 1997; Karpoff and Malatesta, 1989; Meulbroek, Mitchell, Mulherin, Netter, and Poulsen, 1990; and Yermack, 1996 for companies in the US, and Campbell and Keys, 2002; Ees, Postma, and Sterken, 2003; Mitton, 2002; Morck, Nakamura, Shivdasani, Prevost, Rao, and Hossain, 2002; and Volpin, 2002 for companies in other countries.

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

[17]Also see Gillan and Starks (2000), Del Guercio and Hawkins (1999), and Prevost and Rao (2000).

[18]http://www.tiaa-cref.org/siteline/siteline_article_5_528_38329.html

(potential) shareholder proposals and their effects.

The empirical evidence on the influence of shareholder activism has shown mixed results. Although studies have found some short-term market reaction to the announcement of certain types of activism, there is little evidence of improvement in long-term stock market performance or operating performance resulting from the activism. Studies have found some change in the real activities of the firm subsequent to the shareholder pressure, but it has been difficult to establish a causal relationship between shareholder activism and these changes.

C. Shareholder Activism and Institutional Investor Monitoring in Other Countries

Shareholder activism has not been confined to the US. There have been a number of shareholder rights groups in other countries as well. According to Arnold and Breen (1997), the roots of the VEB, the Dutch Shareholders Association, date from 1924, when the association was founded to represent both institutional and individual investors. Shareholder associations have existed in Germany and Sweden since the 1960s and new groups have developed more recently in other European countries. The authors further point out that mutual funds and newly privatized pension funds in Europe have developed into prominent shareholder activists. In the UK, eight major institutional investors, representing over 5% of the UK stock market, recently wrote to the CEOs of 750 UK companies requesting that they voluntarily put their compensation reports to a shareholder vote. Activist investor groups have also developed in Asia. For example, a group developed in Malaysia in August 2000 included institutional funds whose equity holdings accounted for 25% of the Malaysian market capitalization.

Despite these recent developments, US institutions take a relatively more active role than institutions in other countries. An examination of proxy voting by institutional investors in other countries alone shows substantial contrast to the US. In the US, voting turnout, the level of votes represented at the annual meeting, can easily reach 70-80% at many companies (Bethel and Gillan, 2002.) Although it is estimated that institutional investors in the UK own between 65% and 80% of the equity markets, they have, at least historically, not voted their shares.[19] Mallin (1995) notes that of 250 large UK companies surveyed, 90% report voting levels of less than 52%. The Report of the Committee of Inquiry into UK Vote Execution (sponsored by the National Association of Pension Funds (NAPF)) reports voting levels at UK companies were as low as 20% in 1990, increasing to 50% by 1999.[20] This increase might be attributable to external pressures on institutions to actively vote their shares. In 1998, the Trade and Industry Secretary threatened legislative action if institutional investors did not improve their voting records. Thus, although a voting turnout of 50% is evidence of an increase, it is still low by US standards. In Australia, the voting turnout is even lower, at 39-41% of shares.

The differential between voting turnout in the US and other countries could be due in part to differences in the institutional and regulatory environments. For example, in the US, the Department of Labor mandates that pension funds regulated by the Employment Retirement Income Security Act (ERISA) should vote their proxies and communicate with corporate management if such activities are likely to increase the value of the funds' holdings.

In Korea, laws in place prior to 1998 prevented financial institutions from voting their shares. According to Joh (2001), although institutional investors owned 40% of the publicly traded companies' shares, there existed a "shadow voting" rule which prevented financial institutions from voting those shares. Rather, votes by financial institutions (which in aggregate owned about 20% of the shares) were cast in the same proportions as votes by the nonfinancial institutional shareholders. Further, Choi and Cho (2003) suggest that most activism has been conducted by a non-governmental organization, but that this organization has had little success.

Black and Coffee (1994) argue that British institutions, in particular British insurance companies, are more active than their American counterparts. They discuss the differences in activism across types of British institutions and conclude that insurance companies are the most active, followed by pension funds. They find little interest in activism by British mutual funds and even less interest by British banks, which are generally disinterested in share ownership (in contrast to banks in Japan or Germany).

Frydman, Pistor, and Rapaczynski (1996) study the behavior of 148 voucher investment funds after mass privatization in Russia. They focus on whether these funds tended toward voice (shareholder activism) or toward exit (trading), arguing that these two strategies have very different costs and benefits in transitional economies such as Russia, as opposed to the more developed economies of the US or the UK. They found that activism was a strong component of the voucher

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

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

fund activities, with 79% of the funds reporting that they held seats on the boards of the corporations in which they held equity. They also found that trading was "surprisingly important" for these funds, with 57% reporting that they were trading in the secondary market.

Regardless of their activism, a McKinsey survey of more than 200 institutional investors with investments across the world shows that governance is a significant factor in their investment decision (Coombes and Watson, 2000). Three-quarters of the investors say that board practices are at least as important as financial performance. In fact, over 80% of the investors in the survey stated that they would pay more for the shares of a well-governed firm than a poorly governed firm with comparable financial performance. (In this case, well-governed was defined as a firm that has a majority of independent directors, undertakes formal evaluation of directors, and is responsive to requests from investors for information on governance issues.) The survey indicated that the premium these institutional investors would be willing to pay varied by country, with premiums being higher in Asia and Latin America (where financial reporting is less reliable) than in Europe or the US.

In a separate survey of pension funds and investment managers, Useem et al. (1993) found that the composition and function of the board were critical to these institutional investors. In particular, a primarily independent board, with some diversity of skills and experiences and ownership in the firm, was considered important.

D. The Influence of the Legal Environment

The legal system within a country further influences the role of institutional shareholders. For example, an institution's ability to monitor the firm by means of voting might be limited by certain features of the legal and regulatory environments. In some European countries, the voting system entails "share blocking," which requires shareholders wishing to vote to hold their shares and show up at the annual meeting (in contrast, in the US, those who hold shares as of the date of record are permitted to vote at the annual meeting.) This highlights the potential tradeoff between liquidity and control, as "blocking" the shares effectively prohibits the investor from trading prior to the annual general meeting. Share blocking likely contributes to low voting turnout at some companies.

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

More generally, differences in countries' legal and financial systems have led to a disparity in corporate governance systems.[21] For example, La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1997) argue that investor protection and corporate governance are stronger where the legal system is based on common law as opposed to civil law. Roe (1990) contends that in the early part of the twentieth century, institutions in the US were active in corporate governance, but the federal government curtailed their participation. To be sure, the roles of institutional investors worldwide differ due to differences in various countries' stages of development and laws that govern their behavior. It has been suggested that laws affecting the role of institutional investors are the major reason for evolutionary differences between corporate governance systems in the US and those in other countries, such as Germany or Japan.[22]

Interestingly, Palepu, Khanna, and Kogan (2002) suggest that pairs of economically interdependent economies tend to adopt similar corporate governance standards after controlling for the effects of legal origin. Nevertheless, legal protection of shareholders, particularly minority shareholders, is important for corporate governance and for the continued ability of firms in emerging markets to attract foreign capital (La Porta et al., 1997).[23] As these firms press for more funds, foreign investors will demand stronger legal protections and corporate governance, acting as catalysts to improve the climate of these growing economies.

III. Ownership Structures

Our discussion now turns to ownership structure

[21]Other aspects of the legal system can affect corporate governance as well. Maug (2002) argues that insider trading legislation has effects on the monitoring by large shareholders. Booth, Cornett, and Tehranian (2002) provide evidence that regulation can substitute for internal monitoring mechanisms.

[22]By design, institutions, particularly banks, have played a large role in the ownership and monitoring of corporations in Germany (the *Hausbank*) and Japan (the *Keiretsu*). In other markets family or business groups appear to be dominant players. See, for example, Campbell and Keys (2002) and Ferris, Kim, and Kitsabunnarat (2003) for a discussion of the *chaebol* in South Korea and Khanna (2000) for a discussion of business groups more generally.

[23]Goetzmann, Spiegel, and Ukhov (2002) show, however, that differences in value of two classes of securities that might at first appear to be due to corporate governance, cannot in fact, be ascribed to that explanation.

and the influence on corporate governance more generally. Specifically, we focus on differences in ownership structures across countries in Subsection A, and the potential for foreign institutional investors to promote governance changes in Subsection B.

A. Differences in Ownership Structure across Countries

In many economies, large shareholders and concentrated ownership, as opposed to institutional ownership, are important factors in a firm's governance structure. As noted earlier, the agency problems between managers and shareholders as envisioned by Berle and Means (1932) and Roe (1990) might not be prevalent in economies where ownership structures differ. Indeed, LaPorta, Lopez-de-Silanes, and Shleifer (1999) conclude that in many economies the primary agency problem is that of restricting expropriation of minority shareholders by the controlling shareholders, rather than that of restricting the activities of professional managers unaccountable to shareholders. According to these authors, controlling blockholders in these economies have the ability to enjoy private benefits of control at the expense of other shareholders.

There is striking variation of ownership structure internationally. Majluf, Abarca, Rodriguez, and Fuentes (1998) report that although the largest shareholders in Chile control 40% of the shares of the largest companies, this drops to 22% for Germany, and 7% for Japan. In the US, however, there is substantially more dispersion in share ownership, and the largest shareholder often controls as little as 5% of voting rights. There can also be differences between the largest shareholder and the largest shareholder group. Prowse (1992) provides evidence that the top five shareholders in Japan own over 30% of the shares of publicly traded firms. LaPorta, Lopez-de-Silanes, and Shleifer (1999) report that, for a sample of large publicly traded firms around the world (the largest 20 firms in each country), 36% were widely-held, 30% were family-controlled, 18% were state-controlled, and the remaining 15% exhibited a variety of other ownership structures. The authors found that major shareholders primarily used pyramidal structures, rather than differential voting rights, to control firms. Some 26% of their sample firms had pyramidal structures (multiple layers of corporate ownership which permit control of voting rights with relatively low levels of investment). In the average country, family owners controlled 25% of the value of the largest 20 firms. Finally, La Porta et al. (1999) found little evidence of control by single financial institutions, such as banks (other than in Germany), and little evidence of cross-shareholdings by other corporations. Faccio and Lang (2002) examine ownership and control of over 5000 corporations in Western Europe. They find that companies are either widely held or family-controlled with little use of multiple class voting shares or pyramid structures.

Consistent with the Faccio and Lang (2002) study, Becht and Roell (1999) provide evidence of dominant block ownership for firms domiciled in Austria, Belgium, France, Germany, Italy, Spain, and The Netherlands, (with less evidence of dominant block ownership in the UK). In many of these countries the largest voting stake for the median firm in their sample exceeded 50%. The authors conclude that in much of continental Europe there exist large blockholders who can and do exercise control over management. Consistent with LaPorta, Lopez-de-Silanes, and Shleifer (1999), the authors also conclude that the main conflict of interest lies between controlling shareholders and minority shareholders as opposed to dispersed owners and professional managers, as in the US.

Claessens, Djankov, and Klapper (2000) compare group affiliation in seven East Asian countries and Chile. They find that 75% of the listed firms in their East Asia sample are associated with business groups, compared to 40% in Chile. Valadares and Leal (2000) find a high degree of ownership concentration in publicly traded companies in Brazil, providing evidence that the major shareholder owns an average 41% of the equity capital.[24]

The East Asian environment parallels that of Western Europe in a number of ways. Claessens, Djankov, Fan, and Lang (2002) argue that the separation between voting and cash-flow rights in East Asian corporations is associated with the potential expropriation of minority shareholders and lower market values. Moreover, Fan and Wong (2002) find that earnings are less informative in the presence of concentrated ownership, pyramidal ownership structures, and cross-holdings. Faccio, Lang, and Young (2000) argue that East Asian capital markets generally appear capable of containing expropriation within tightly controlled groups by requiring that higher dividends be paid by corporations affiliated with such groups. The authors argue that these capital markets fail to extract higher dividends from corporations in groups with only intermediate levels of control. Thus, a greater discrepancy between ownership and control is associated with lower dividend rates. Offering a different perspective, Rajan and Zingales (1998) suggest that such relationship-based systems work well in environments with weak legal protection and scarce capital, but tend to break down and misallocate resources when faced with large

[24]For further discussion of the effects of institutional investors on corporate governance in Latin America, see Starks (2000).

external capital inflows.

The differences in ownership structures, the legal environment, and the role of institutional investors across countries can have diverse effects. For example, Brunello, Graziano, and Parigi (2003) argue that concentrated ownership, family control, limited institutional investor activism, and lack of bank monitoring result in the Italian corporate governance structure that is dominated by insiders. Studying CEO turnover in Italian firms to determine whether such a structure can still provide sufficient monitoring, the authors conclude that boards of directors dominated by insiders (who are not the CEO) can provide a monitoring mechanism that substitutes for the lack of independent directors. In addition, Leuz, Nanda, and Wysocki (2003) show that although differences in ownership concentration may affect earnings management within a given country, these differences do not explain variations in earnings management across countries. Finally, Dahlquist, Pinkowitz, Stulz, and Williamson (2002) argue that the concentrated ownership prevalent in many countries explains the home bias of investors.

B. Foreign Institutional investment and Corporate Governance

Equity ownership by foreign institutional investors can have an important relation to the prevailing corporate governance within a country and within a firm, although the endogeneity of the relation makes it difficult to determine causality. On the one hand, firms (and countries) may be motivated to improve their corporate governance in order to attract foreign capital. On the other hand, increased investment by foreign institutions may provide those institutions with the power to enforce governance changes.

Regardless of the direction of causality, increased foreign institutional investment has become an important influence in many economies, particularly emerging economies, as the demands for capital in these countries have increased. According to a recent IMF report, the issuance of bonds, equity, and syndicated loans in emerging markets increased by 32% during 2000 to some US $216 billion. Equities alone increased by 80% to US $41.8 billion, the highest level ever. Further, private sector entities raised approximately US $86.7 billion of debt, with China accounting for about 50% of new issues during 2000 (Mathieson and Schinasi, 2001).[25]

Due to the increased globalization of their investments during the past decade, foreign investors have had a large influence on emerging equity markets and the firms traded in these markets and this can be expected to continue. Foreign investors can affect the firms' corporate governance either through direct intervention or through indirect supply-demand effects. CalPERS and TIAA-CREF, for example, have directly sought to improve corporate governance systems in their holdings, whether domestic or foreign. In some cases, foreign institutions may exert significant influence due to their large presence in the markets, particularly as they may hold more shares than domestic institutions. For example, recently Mexico's stock markets had over 30% foreign investment, while its domestic mutual fund industry held about 1% of outstanding equity (Cervantes, 1999). Institutional investors do, however, face impediments: the costs of intervention, the limited number of other institutions that choose to help with an intervention, and legal restrictions on activities (including ownership and voting rights) of foreign institutions.

Karmin (2000) notes that some markets now have problems attracting foreign institutional investors. "Unless companies start paying more attention to corporate governance, emerging markets could remain stuck in the backwaters of global finance for years to come. Many investors say it is easier to 'vote with their feet' and simply abandon many of these markets." Indeed, CalPERs recently began to eliminate its public equity investment positions in Indonesia, Malaysia, and Thailand, a move at least in part attributed to poor corporate governance.[26]

In addition to direct intervention by foreign investors, indirect supply-demand effects may lead to improved governance. Evidence seems to indicate that there is a relation between changes in corporate governance structures and changes in foreign investment. For example, Mitton (2002) suggests that during the East Asian financial crisis more focused firms and those with higher quality disclosures and more concentrated outside ownership had better stock price performance. Evidence also exists of a correlation between the market value and corporate governance of Russian firms (Black, 2001) and Korean firms (Black, Jang, and Kim, 2003). Consistent with these findings, Klapper and Love (2002) argue that firm-level governance provisions are more important in countries with weak legal environments. Thus, firms that improve their governance and credibly commit to protecting shareholders can compensate for a weak legal

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

[26]The decision to change allocations was based on a review of each market based on a number of factors including: market liquidity and volatility, market regulation and investor protections, capital market openness, settlement proficiency, and transaction costs (accounting for 50% of the review). Political stability, financial transparency and labor standards accounted for the remaining 50%.

environment.[27] Further, Aggarwal, Klapper, and Wysocki (2003) find that US mutual funds tend to invest greater amounts in countries with stronger shareholder rights and legal frameworks (controlling for the country's economic development). In addition, within the countries, the mutual funds also discriminate on the basis of governance in that they allocate more of their assets to firms with better corporate governance structures.

Studies of foreign firms that are cross-listed in the US also find that institutional investors prefer better governance structures. A number of studies (e.g., Coffee, 1999, 2002; Stulz, 1999; Reese and Weisbach, 2002; and Doidge, Karolyi, and Stulz, 2003) argue that firms choosing to cross-list in the United States reduce the agency problem of controlling shareholders trying to expropriate from the minority shareholders. That is, because the firms enjoy greater investor protection in the US, shareholders of cross-listed firms are better off.

Other evidence is also consistent with this argument. Doidge et al. (2003) find that the cross-listed firms have higher values than firms from the same country not listed in the US.[28] Reese and Weisbach find that the benefits of cross-listing extend to minority shareholders in the home country in that the cross-listed firms raise more equity at home following the listing. Eleswarapu and Venkataraman (2003) provide evidence that the trading costs of cross-listed firms in the US depend on the corporate governance environment in the home country.

Counter to these arguments, La Porta, Lopez-de-Silanes, and Shleifer (1999), La Porta, Lopez-de-Silanes, Shleifer, and Vishny (2000), and Seigel (2002) maintain that cross-listing in the US is not sufficient to overcome poor corporate governance practices in the home country.

Analysts, however, seem to be attracted to companies with better corporate governance structures as well. Lang and Lundholm (1996) and Healy, Hutton, and Palepu (1999) provide evidence that US firms with increased disclosure have greater analyst following. In an examination of 2510 companies from 27 countries, Lang, Lins, and Miller (2002) conclude that analysts heavily weigh corporate governance when deciding which companies to follow. They find that analysts are less likely to follow firms in which there is family or management control. Further, Bushman, Piotroksi, and Smith (2001, 2002) find positive correlations between the enactment and the enforcement of insider trading laws (indicating more investor protection) and analyst following. There is also relevant evidence in the research on firm accounting choice and foreign investment. Bradshaw, Bushee, and Miller (2002) find that firms whose accounting methods conform with US Generally Accepted Accounting Principles (GAAP) have a greater level of investment by US institutional investors. They find further that increases in conformity with US GAAP are positively associated with future increases in US institutional investment, but that the reverse does not hold (i.e., increases in US institutional ownership are not associated with later changes in accounting methods). The authors attribute this relation to home bias rather than better transparency (and corporate governance), however, their results are also consistent with the latter interpretation.

A further example of the indirect influence of a firm's corporate governance structure in attracting capital is the development of corporate governance ratings services. Déminor has established a service providing research on the corporate governance practices of the Financial Times Stock Exchange (FTSE) Eurotop 300 index companies, covering 17 European countries. Déminor bases its ratings on corporate governance criteria spanning four main areas: 1) rights and duties of shareholders, 2) absence of takeover defenses, 3) disclosure, and 4) board structure. In Russia, the Institute of Corporate Law and Corporate Governance evaluates companies for corporate governance efficiency and provides corporate governance ratings. Standard and Poor's has developed a corporate governance rating system for emerging markets (Cullison, 2000). Credit Lyonnais Securities Asia's Emerging Markets Division has also released corporate governance rankings for 495 companies in 25 countries. Moreover, during recent months no fewer than four rating services have been announced for US firms – The Corporate Library, GovernanceMetrics, Institutional Shareholder Services, and Standard and Poor's. The existence of such services reflects a perceived institutional investor demand for information in order to make investment decisions.

Corporate governance at the stock exchange level also appears to be related to firms' liquidity. Frost, Gordon, and Hayes (2001) find evidence that the strength of a stock exchange's disclosure system (disclosure rules, monitoring and enforcement, and information dissemination) is positively associated with the liquidity of stocks traded (after controlling for stock exchange size, legal system, and proxies for market development and information environment).

Despite the ability of shareholders to sell, and firm-specific actions to improve corporate governance,

[27]In related work, Carlin and Mayer (2000) argue that corporate governance systems are strongly related to economic development and Lefort and Walker (2000b) examine the effects of economic and political shocks on the development of corporate governance systems.

[28]Similarly, Lee and Ng (2002) present a theory and provide evidence that firms from more corrupt countries are valued less by investors than are firms from less corrupt countries. Their definition of corruption is the misuse of public office for private gain.

pressure for governance reform remains strong in many markets. For example, Anthony Neoh, senior adviser to the China Securities Regulatory Commission, has stated that China must improve the corporate governance of enterprises (Deutsche Presse-Agentur, 2001). Similar sentiments aimed at attracting and retaining capital appear to underlie the promulgation of corporate governance codes of best practice in many markets. The development of governance codes, oftentimes with legislative backing, is taking place in developed countries such as Hong Kong, Singapore and The United Kingdom, and in emerging markets such as Brazil, India, and Thailand, among others. Moreover, recent events in the US, including the failures of Enron and Worldcom, have sparked a wave of regulatory reform addressing corporate governance concerns.[29]

IV. Conclusions

We examine the role of institutional investors in financial markets and the governance of corporations. Previous research tells us that institutional investors are the predominant players in some countries' financial markets and are therefore important in corporate governance. Yet, ownership structures and other governance characteristics differ across markets. These differences are attributable in part to legal and regulatory systems and in part to the manner in which the markets have evolved. For example, the interrelation between institutional investors and other factors of corporate governance such as the market for corporate control, the board of directors, large blockholders, lenders, and employees may affect their importance in a particular market. Furthermore, ownership structures may change for many reasons, including the development of pension systems, financial liberalization, the investment policies of foreign institutional investors, privatization initiatives, the establishment of stronger shareholder protections, or other environmental, legal, and regulatory changes.

Despite these differences across markets, due to the growth in institutional ownership and influence worldwide, institutional investors have the potential to play an important role in many markets. Previous researchers have shown that because of the costs involved, only large shareholders have the incentive to provide extensive monitoring of management. Whether institutions as large shareholders should, or will, provide such monitoring depends in part on the constraints to which they are subjected, their objectives, and their preferences for liquidity. These characteristics will continue to vary across countries, leading to differences in the role and influence of institutional investors in corporate governance.

On balance, we expect that institutional investors will increase the liquidity, volatility, and price informativeness of the markets in which they invest. In turn, the increased information provided by institutional trading should result in better monitoring of corporations and in better corporate governance structures. In some cases, financial liberalization and aspects of government policy will be the major drivers of change, suggesting that the role of institutional investors will be a minor one. In other cases, institutional investors, foreign and domestic, will play a major role, particularly given the capital they control.

The trade-off between the concentration and dispersion of ownership found across countries raises further questions that research needs to address. First, to what extent do diverse types of equity owners (e.g., domestic institutional investors, employees, large blockholders, and foreign institutional investors) participate in corporate ownership? Second, how does the interaction of these investors affect corporate governance structures? Third, does the increased presence of institutional investors (domestic or foreign) causes corporate ownership in general to become more dispersed, changing firms' corporate governance structures? Finally, does dispersed ownership lead to more efficiently managed firms or do agency problems become magnified in the absence of large blockholders with incentives to monitor?

Since the relative roles of institutional investors and large blockholders are not well understood, how they affect markets also becomes an important issue to consider. Although their roles can overlap, as mentioned previously, there is only modest evidence that corporations change when an institutional investor takes on the role of an activist blockholder.[30] On the other hand, there is evidence that corporate performance improves after an activist share block purchase. There is no doubt that corporate governance structures are likely to evolve as endogenous responses to environmental factors. From the policy perspective, the goal should not necessarily be to encourage one form of ownership over another, but to facilitate the efficient use of capital. Legal and regulatory approaches that advocate disclosure, transparency, investor protection, and the establishment of property rights are likely to prove central to encouraging capital investments by many different types of shareholders.

Regardless of how different types of owners interact, the implications of the previous research are that the presence of institutional investors should lead to more informative prices, and consequently lower monitoring costs for all investors. Thus, the outcome should be better monitoring of managers and better corporate governance.■

[29]See Gillan and Martin (2002) for a discussion of Enron.

[31]One study that examines the monitoring role of different types of investors is Franks, Mayer, and Renneboog (2001), who find that there are differences across the monitoring parties and across countries.

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