Institutional Investors and Corporate Behavior

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1
Introduction

Institutional investors are to students of corporate governance what banks were to Willie Sutton—they're where the money is. But they weren't always.[1] As recently as 1980, institutional investors—principally banks, insurance companies, mutual funds, private pension funds, and state and local government pension funds—held only 36 percent of U.S. equities. By 1997, this figure had risen to 55 percent. Among the stocks in the Standard & Poor's 500, the concentration is even greater, with 57 percent held by institutional investors in 1997, up from 46 percent in 1980.

This sea change in equity ownership mirrored the shift in household portfolio composition away from direct ownership of financial claims and toward ownership through financial intermediaries. Lower transaction costs of mutual funds, tax-favored promotion of pensions and saving, and the increased willingness of state and local government retirement funds to hold equities contributed to the new importance of institutional investors.

While equity holdings by institutional investors have grown substantially since 1980, they have not grown uniformly. In particular, holdings by banks and insurance companies have declined in relative importance to holdings by mutual funds and pension funds. Since 1990, the period of the most explosive growth of institutional-investor holdings, the greatest relative growth has been of holdings by mutual funds and private pension funds.

Given the rising importance of institutional investors as shareholders of U.S. corporations, one might ask

whether those large shareholders can improve corporate performance. Exploring these questions is tricky because it calls for an investigation of institutional investors' attitudes toward monitoring and governance, and of the degree to which investors' actions actually affect corporate performance.

Calls for institutional investors "to not just sit there, but to *do* something" reflect their importance as shareholders and an intuitive belief that they may be skillful at improving the performance of firms. Nonetheless, to the casual observer there may appear to be a wide gulf between practitioners' views about the value of institutional-investor activism in corporate governance and the views of financial and legal researchers. The nub is this: in theory, institutional investors' concern over corporate-governance practices is a good thing (see, for example, MacAvoy and Millstein 1998), but compelling empirical evidence linking activism and performance is mixed or lacking (see, for example, the reviews in Black 1998b and Karpoff 1998).

To bridge the gap between academic research and practitioners' beliefs, we interviewed senior officials (the chief executive officers, chief financial officers, chief investment officers, or general counsels) of ten large institutional investors (mutual and pension funds) holding combined equity assets in the third quarter of 1998 of approximately $1 trillion. Using a detailed survey and personal interviews, we explored the mechanics of proxy voting, investors' views of monitoring and corporate governance, and the benefits and costs of governance-related activism. Our interviews provide a bridge between academic and practitioner views.

Among our findings are the following:

- All institutional investors have improved their efforts at proxy analysis and voting in recent years by developing in-house proxy-administration departments and employing voting services and consulting firms such as

Institutional Shareholder Services (ISS) or the Investor Responsibility Research Center (IRRC).

- Though institutional investors agree broadly about the importance of shareholder rights, effective boards, and efficient CEO compensation and succession for corporate performance, the true economic value of “good governance” and the effectiveness of shareholder activism are still matters of much debate in the industry, particularly among private mutual-fund investors.
- And though investors may refer to “corporate governance” in their monitoring and intervention, informal or formal investor actions relate far more frequently to perceptions of poor performance. Except in highly publicized cases involving allegations of excessive executive compensation, dysfunctional boards, or fraud, it is generally only after firms are identified as troubled or as long-term underperformers that governance practices are given more than routine scrutiny.
- Institutional investors view good governance as most valuable when a firm or its industry is in trouble. Despite differing views on the general value of good-governance practices, all investors in our sample agreed that having an independent board, solid succession plans, and shareholder rights unfettered by restrictive anti-takeover measures helps to ensure the fastest possible recovery for the firm and for share values.
- While many commentators note that “private mutual-fund” and “pension-fund” institutional investors differ in their assessments about both the costs and the benefits of shareholder activism, we find that this disparity is less clear than it might appear at first glance. Many institutional investors themselves are skeptical of institutional investor activism per se. Indeed, most investors stress monitoring and activism in relation to measures of performance, as opposed to governance in isolation.

These results support the idea that concerns over corporate-governance practices are important. All the in-

stitutional investors we interviewed expressed detailed and well-researched views on corporate governance. Our findings suggest the desirability of reorienting academic inquiry toward three questions. First, does the perceived importance of corporate-governance "best practices" translate into improved corporate performance? Second, are institutional investors more likely to choose companies that display these characteristics or to encourage the development of these characteristics? Third, does the emphasis on the importance of good governance in "bad times" suggest pitfalls in attempting to ascertain links between governance and performance in simple descriptions of a linear relationship between governance and performance?

Our intention in this study is, first, to evaluate previous research on shareholder activism and its consequences, then to describe our survey and interviews and the key response trends we observed, and, finally, to discuss potential avenues for additional research suggested by the interviews.

2
Institutional Investors, Governance, and Performance

The call for institutional investors to not just sit there, but rather to do something, reflects a recognition of their importance as shareholders and the expectation that they may be skillful at improving the performance of firms (following the historical example of J. P. Morgan; see DeLong 1991). While institutional investors have been active individually and collectively in discussions of corporate governance and links between corporate governance and corporate performance, political constraints remain on their ability to intervene directly or through improvements in the market for corporate control (see, for example, Black 1990 and Roe 1993a, 1993b, 1994).

What Can Institutional Investors Do?

In the United States, institutional-investor activism is generally accomplished either through informal discussions with management ("jawboning") or through presenting (or advancing the possibility of presenting) a governance-related shareholder proposal at the firm's annual shareholder meeting. In chapter 3 below, we review ways in which institutional investors view the benefits and costs of those alternative ways of exercising "voice."

Although informal discussions can proceed in a number of ways (see chapter 3 below and Grundfest 1993), shareholder proposals generally follow a more prescribed pattern. Rule 14a-8 (promulgated by the Securities and

Exchange Commission) allows a shareholder to incorporate a proposal and supporting statement in the proxy statement to be distributed by the company prior to the shareholder meeting. While such a route is relatively inexpensive for an institutional shareholder, the proposal filing is subject to free-rider problems (Admati, Pfleiderer, and Zechner 1994), and the proposal, limited to certain subjects, must be submitted up to six months prior to the shareholder meetings.[2] The low levels of spending on governance estimates may attest to the severity of free-rider problems or to the failure of activism to pass a simple benefit-cost test (see Pozen 1994).

In general, proposals filed under the aegis of Rule 14a-8 relate to shareholder rights (for example, the weakening or redemption of poison-pill provisions) or to the composition and responsibilities of the board of directors (for example, the increased independence of directors on nominating and compensation committees of the board, cumulative voting, the elimination of staggered terms for directors, or separating the chairman and chief executive officer positions).[3] As we describe later, institutional investors generally develop guidelines for introducing or voting on proposals.[4]

Researchers have documented the relative importance of pension-fund investors (state and local government pension funds) in proposal submission. This differential willingness to submit relative to other institutional investors might reflect a different perception of benefits and costs by value-maximizing investors (see, for example, Black 1990 or Pozen 1994) or the political (non-value-maximizing) motivations of state and local pension funds (as in Romano 1993).

Few institutional investors submit shareholder proposals (see Daily, Johnson, Ellstrand, and Dalton 1996), and the proposals they do submit have been identified as targeting underperforming firms as opposed to targeting non-performance-related issues (Karpoff, Malatesta, and Walkling 1996). The balance between quiet negotiations

and public discussion varies across firms (see chapter 3 below and the case study of CREF by Carleton, Nelson, and Weisbach 1997). The likelihood of a proposal's success has less to do, empirically speaking, with the level of institutional ownership (see Gordon and Pound 1993 and Bizjak and Marquette 1997) than with whether Institutional Shareholder Services (ISS, a consulting firm that provides both voting services and voting advice to institutional investors) recommends support (Black 1998b). The prominence of ISS likely reflects both the increased importance of institutional investors as corporate shareholders and the role of ISS as an intermediary, economizing on institutions' costs by evaluating proposals.[5]

What Do Institutional Investors Do?

One obvious benefit of a competitive market for institutional-investment vehicles is the reduction of the transaction costs of investing for small savers. This benefit arises even if there are no information or incentive problems in the governance of corporations. In addition, relative to the unconcentrated holdings of many small shareholders, large holdings by institutional investors might be used to monitor managers or to persuade management of the wisdom of certain governance arrangements (for example, composition of the board of directors or compensation mechanisms for senior executives) or of abandoning activities perceived by investors to be non-value-maximizing (for example, certain acquisitions or diversification strategies).

Two questions arise when we consider the logical chain from institutional ownership to corporate governance to corporate performance. First, do institutional investors have preferences for particular corporate-governance mechanisms? Second, does the use of certain corporate-governance mechanisms affect shareholder value? Answering the first question requires an exploration of the views of large institutional investors, which we describe in chap-

ter 3. Such an exploration can shed light on investor perceptions about these two questions and on how those perceptions might guide empirical research in corporate finance, law, and economics.

Academic responses to the questions are mixed. At one level, it is not difficult to imagine why this might be so. In the absence of frictions in the market for corporate control, there should in principle be no causal link between the use of a governance variable (for example, managerial ownership or board composition) and performance (for example, accounting measures of profitability or shareholder firms). Firms would substitute different mechanisms in different ways (that is, varying in the relative reliance on alternative mechanisms), but no gain in performance could be obtained by pushing firms to use more of a particular mechanism.[6]

In practice, however, the market for corporate control is not perfect, so that one might reasonably ask whether the adoption of or increased reliance on certain governance mechanisms increases corporate performance. Unfortunately, empirical evidence on performance consequences of institutional-investor activism or of corporate-governance mechanisms is not abundantly available.

On the general issue of the effects of institutional-investor monitoring and activism, researchers have pursued a number of lines of inquiry, including direct links between institutional ownership and performance and links between institutional-investor targeting or proposals and shareholder returns. For the former, while there is evidence of a correlation between institutional ownership and Tobin's *Q* (akin to the ratio of the market value of the firm divided by the book value of assets),[7] a causal interpretation is unclear. Institutional investors may, for example, be more likely to acquire shares in firms with high growth prospects or intangible value—in short, high-*Q* firms.

The evidence linking institutional-investor activism and firm performance is also ambiguous. On the one hand,

many empirical studies fail to find a correlation between performance (that is, return on equity, assets, or excess returns) and current or lagged values of institutional ownership, or ownership by institutions that have submitted shareholder proposals (see, for example, Daily, Johnson, Ellstrand, and Dalton 1996; Karpoff, Malatesta, and Walkling 1996; Carleton, Nelson, and Weisbach 1997; and Gillan and Starks 1997). Finally, empirical researchers have found no consistent evidence of positive abnormal stock-price returns immediately following the announcement of a formal shareholder proposal (see Karpoff, Malatesta, and Walkling 1996; Wahal 1996; Carleton, Nelson, and Weisbach 1997; and Gillan and Starks 1997).

On the other hand, Nesbitt (1994) concludes that firms targeted by the California Public Employees' Retirement System (CalPERS) experience positive long-run stock-price returns. Opler and Sokobin (1997) find that in the year after being targeted by the Council of Institutional Investors, firms showed significant above-market performance. MacAvoy and Millstein (1998) suggest that while empirical proof is desirable and should be pursued, "observation, experience, and logical assumptions" nevertheless seem sufficient basis for the contention that active, independent boards improve corporate performance.[8]

These more sanguine views of the effectiveness of institutional-investor activism nonetheless raise questions. Other researchers have documented positive returns to firms performing poorly ("mean reversion"), including firms targeted and not targeted by CalPERS (see, for example, Wahal 1996 and Del Guercio and Hawkins 1997). Moreover, the large effects documented by Opler and Sokobin (1997)—a median abnormal return of 9 percent—cause us to question what large imperfections block the market for corporate control—especially given the fact that targeting by the Council of Institutional Investors need not imply activism by individual institutional-investor members. Finally, activism might have positive effects because it is the culmination of effective monitoring or dis-

cussions with management (see, for example, the discussion in Wahal 1996 or Strickland, Wiler, and Zenner 1996).

Two problems of study design complicate research in this area. First, despite popular discussions linking activism with disagreements about corporate governance, institutional investors often single out poor performers for shareholder proposals, making it necessary to isolate a group of comparable, poorly performing firms to study the consequences of activism. Second, inquiries into the consequences of activism for performance have to address whether particular governance mechanisms actually affect performance. Here, too, the available evidence is ambiguous (see, for example, Bhagat and Black 1998 on independent directors; Brickley, Coles, and Jarrell 1997 on separating the chief executive officer and chairman of the board of directors; and Himmelberg, Hubbard, and Palia 1999 on managerial ownership).

These problems of study design highlight the desirability of qualitatively investigating the attitudes of institutional investors toward corporate governance, and the extent to which such investors believe that changes in governance might affect corporate performance. Such an inquiry can shed light on whether governance issues appear to be of concern to the institutional-investor community, and on how empirical researchers might design a meaningful test of cross-firm variation in the use of alternative governance mechanisms and within-firm variation in performance, explainable by changes in corporate governance.

3
Survey and Interview Results

There has been much speculation about institutional-investor philosophy and its meaning for corporate governance, but conclusive findings are scarce. Analysts have theorized a great deal about investor motives and strategy, but with little or no direct substantiation by the investors themselves. In this study, we attempt to bridge this information gap by using in-depth personal interviews with senior officials in a variety of institutional-investment firms.[9]

Rationale for In-Depth Interviews

We designed and pre-tested an intensive survey instrument to: (1) discover the various methods by which institutional investors carry out their fiduciary and other responsibilities in the area of corporate governance; (2) gather information from investors about how they monitor the governance of firms whose shares they hold; and (3) elicit opinions on the nature and frequency of various forms of shareholder activism and about their effect on firm performance.[10]

We selected survey subjects from the private mutual-fund, public pension-fund, and corporate union professional pension-fund universes, and we contacted each in advance of the interview to secure participation and to provide them with the opportunity to consider the contents of the survey instrument. (As a condition of partici-

pation, all investors in the sample were promised confidentiality—at both the individual and the firm levels—in advance of the interviews. All direct attribution in this study comes from commentary on public record, not from statements by participants in their interviews.) The interviews then took place either in person or, in a minority of cases, over the telephone. In each case, the respondent was a high-ranking official (CEO, chief investment officer, or general counsel) with direct knowledge of the fund's or plan's investment strategies and procedures.[11]

The interview format allowed us to investigate practical and philosophical issues of institutional-portfolio management and their effects on corporate governance to a degree unattainable through research restricted to traditional statistical analysis and surveys of the existing literature. Although the sample is necessarily small, we believe the representation in both the private- and pension-investment sectors reflects diversely the institutional-investor universe as well as the predominant views and practices in contemporary corporate governance. (As of the third quarter of 1998, the aggregate value of equities held by the investors in our sample was approximately $1 trillion,[12] which represents about 9 percent of the total domestic equity-market capitalization for that period.) We believe that the detailed procedural information and candid opinions expressed in the interviews have illuminated crucial misconceptions about the importance of corporate-governance policies and the effectiveness of shareholder activism. Additionally, the results we discuss below suggest several potentially fruitful directions for future research.

The Respondents

In the strictest sense, the investors in our sample fall into the categories of corporate pension fund, state pension fund, union or professional pension fund, and private mutual fund. More generally, however, our results sug-

TABLE 3–1
ALLOCATION OF ASSETS OF PRIVATE MUTUAL-FUND INVESTORS

	Asset Allocation			
Investor	Total equity holdings (range, in $billions)	Domestic equity (%)	Foreign equity (%)	Indexed equity (%)
A Chief Operating/Investment Officer	20–50	≈95	≈5	≈10
B President	> 100	≈90	≈10	≈5
C Senior Proxy Administrator	50–100	N/A	N/A	N/A

NOTE: Each investor represents a private mutual-fund company.
N/A = Not available.
SOURCE: Survey participants.

gest that the investors can be divided into two overarching philosophical groups: pension-fund investors, who tend to believe in the economic value of governance and the effectiveness of shareholder activism, and private mutual-fund investors, who are skeptical of the value of "good" governance practices, especially in the short term, and who as a rule avoid formal shareholder activism. In the discussion that follows, we examine the results of the survey from which these conclusions are gleaned and attempt to reconcile the inconsistency between what investors have said traditionally about corporate governance and their apparent behavior. Before we move forward, however, it is useful to draw a basic picture of each firm in terms of asset allocation (see tables 3–1 and 3–2).

TABLE 3–2

ALLOCATION OF ASSETS OF PENSION-FUND INVESTORS

Investor	*Firm Status*	*Asset Allocation (accounts only for equity investments)*					
		Total equity holdings (range, in $billions)	Domestic equity (%)	Foreign equity (%)	Equity managed internally (%)	Equity managed externally (%)	Indexed equity (%)
D Senior Corporate Governance Consultant	Private pension	> 100	N/A	N/A	≈100	≈0	N/A[a]
E Equity Portfolio Manager	Private pension	< 10	≈64	≈36	≈50	≈50	≈96
F General Counsel	State pension	> 100	N/A	N/A	≈93.5	≈6.5	N/A

G General Counsel	State pension	20–50	≈73	≈27	≈77	≈23	≈42
H Director of Investor Affairs	State pension	50–100	≈84	≈16	≈57	≈43	≈59
I Director of Investment	State pension	< 10	≈67.1	≈32.9	≈0	≈100	≈14.8
J Executive Director	State pension	50–100	≈62	≈8	≈37	≈63	N/A

NOTE: Each investor represents a pension-fund organization.
N/A = Not available.
a. This investor allows a certain portion of each fund within the family to be indexed, but these levels are fluid. For example, if the manager of a fund with $10 billion in equities has active strategies for $7 billion of the equities, then the remaining $3 billion will be indexed. But the index is enhanced using forecasting models to outperform the index by a slight margin, and it will not match the benchmark security for security.
SOURCE: Survey participants.

Principal Themes from Survey Respondents

Our interviews indicate that the true economic value of good governance and the effectiveness of shareholder activism are still matters of much debate. The philosophy and behavior of even those institutional investors who claim that good governance and shareholder activism are important to long-term shareholder value are not always consistent. Much of the existing research on which they stake their governance-adds-value philosophy fails to provide sufficient proof that certain governance practices *do* add value.

In keeping with their skepticism, private mutual-fund investors believe there is no one-size-fits-all approach to corporate governance. They are therefore disinclined to impose on their portfolio firms any form of best-practices model, such as those that have emerged in recent years from leading good-governance proponents in the public arena (for example, TIAA-CREF and CalPERS).

Despite these tactical differences, however, all investors in our survey were able to agree that having strong, independent boards and rigorous enforcement of shareholder rights (that is, plans unfettered by poison pills and other anti-takeover provisions) are important and desirable traits for portfolio firms. Such conditions are seen by all investors in our sample as helpful in limiting periods of poor performance, which all investors acknowledge are a part of any long-term investor-firm relationship.

All of the institutional-investor representatives we interviewed are engaged in some form of monitoring, but the style and intensity of monitoring vary from the relatively passive tracking of firm-management behavior and the price of the stock—where problems are addressed behind the scenes, between fund management and high-level firm management—to complex screening processes. In the latter, firm behavior is broken down into several distinct categories (such as board composition, executive compensation, and anti-takeover measures), and the resulting

data are processed by computer programs that generate detailed lists of governance problems in each firm screened. The latter monitoring style is favored by institutions whose funds are indexed—usually the pension investors, but also large-fund families that include indexed funds. Presumably, such investors cannot use the "Wall Street walk"—selling one's shares in a company whose performance or governance is unsatisfactory—as a response to governance problems in a particular firm. Further, given their long-term investment objectives, the incentive is greater for retirement funds to take up an active, often public role in influencing a troubled firm's governance policies.

At the core of the debate on the merits and wisdom of institutional-investor activism is an uncertainty that can best be described as a cost-benefit question—that is, will formal activism[13] (see, for example*,* Pozen 1994) bring about an increase in the value of the shares held for a price (in time, staff, money, and unwanted publicity) that is offset by the gain? For many pension-fund investors and virtually all private mutual-fund investors, such costs usually outweigh their speculations on potential improvements in performance and stock prices. These speculations are the primary criteria that their fiduciary responsibility generally allows investors to consider in maximizing portfolio value for beneficiaries.

In most cases, without regard to fund orientation, institutional investors look generally to strong boards and capital markets to discipline governance practices. Further, all of the institutional investors we interviewed indicated that an informal, private dialogue (for example*,* by written correspondence, telephone, or face-to-face meetings) with the CEO or other high-level management official is always the first step taken to address a governance-related concern. In most cases, formal shareholder activism is a last resort.

Although private mutual-fund companies generally eschew public activism, some state retirement systems and

other pension funds are willing to take aggressive, high-profile positions. State retirement systems, in far more cases than private mutual-fund companies, appear to believe that activism has a direct, positive effect on shareholder value. Yet according to Pozen (1994), it is rare that most typical governance issues (anti-takeover charter amendments, executive and other management compensation, or board structure) have such a link to value. Moreover, even in cases where such a causal link is plausible, it is difficult to prove empirically. Accordingly, in the face of uncertain returns and high financial and publicity costs, most private investors are discouraged from formal public activism.

The fundamental disagreement between pension-fund investors and private mutual-fund investors on the question of cost-benefit analyses of activism suggests possible flaws in existing empirical literature on governance. For example, in his 1994 article on the "CalPERS effect," Nesbitt suggests that empirical measurements show that CalPERS's activism during the period from 1987 to 1992 resulted in improved firm performance within two years in all targeted companies and a net "activist dividend" in excess of $150 million per year studied. One critical question is, then, How is it possible that private-institutional stakeholders failed to notice such a large profit opportunity?

The Survey Results in Detail

In the first set of survey questions, we sought to understand how institutional investors handle the mechanics of proxy voting; how they advance their investment philosophy and execute their fiduciary responsibility; and which—if any—parts of this process they consider suboptimal or ill-conceived, relative to contemporary market conditions and legislation.

Proxy Statements and Voting Processes. We learned that most institutional investors, regardless of size and affiliation, have similar guidelines for voting proxies and managing proxy records. Most have dedicated committees whose primary responsibility is to gather proxy materials, review them, vote standard issues, and assess special issues (such as social responsibility concerns, anti-takeover measures, and compensation issues) that require review by senior management or a board of trustees. Proxy guidelines are summarized in Appendix A. We learned further that virtually all institutional investors holding foreign equity face logistical problems such as language barriers, voter-agency restrictions in some countries, time constraints, delays in the reception of necessary ballots and related materials, and generally inadequate information on the social, economic, and legal backgrounds in which proxy items are acting. We explore these findings in more detail below.

All investors in our sample have explicit, written proxy-voting guidelines that govern the mechanics of voting. Each firm has a central repository for proxy records, most commonly stored as electronic files on site, at its custodian bank, or by the proxy-voting service (for example, Automatic Data Processing's Proxy Edge service, IRRC's *SmartVoter* service). Using these records they contract for coordination, execution, and record-keeping. Records generated prior to the genesis of electronic databases are usually stored on site in hard-copy form.

Generally, all respondents coordinate the voting of shares across funds under their control. Software such as Proxy Edge manages this function. Only in such cases as an institutional-fund family's incorporating "socially responsible" funds might there be a difference in the way that one fund votes a proxy relative to other funds in the same family holding shares in the same firm.

For most investors, essential proxy policies existed long before their formal codification, which generally took

place in the early-to-mid-1980s. During this period, institutional investors became the majority shareholders in most large, publicly traded firms.[14] In the majority of cases, proxy guidelines include specific rules and stipulations covering fiduciary responsibility,[15] policies on corporate-governance issues, and provisions for voting special issues.

All investors have a distinct proxy committee or group that conceives, administers, and amends the firm's voting and investment policies. An important distinction between public and private funds is that the public funds' policymakers are often elected state officials, and the proxy and investment policies of these funds are often state law (for example, in California or Pennsylvania) or are subject to shareholder approval or public vote. Although their size varies, these committees almost always include the investor's general counsel or other legal staff, the chief investment officer, research staff, and (in most public pension funds and some private mutual funds) corporate-governance specialists. They meet at regular intervals, with most funds convening ad hoc committees as needed.

Many pension funds have all or most of their assets under external management, and in these cases, the contracted fund managers are furnished with the investor's guidelines and are required to work within those confines. The managers are often given broad jurisdiction over straightforward proxy and investment decisions, however, and are asked for advice on special issues and amendments to proxy policies and investment strategies.

For private mutual funds, it is usually the proxy analysts who vote routine proxy issues. Often, however, if a certain issue pertains to management or performance, or if it is a "straight investment call," the equity analyst's or fund manager's views will be solicited. Senior management of the investment organization will generally handle nonroutine governance issues of material significance to the investment organization.

In pension funds, guidelines tend to be broadly inclusive of most proxy issues that could be considered rou-

tine, resulting in perhaps fewer instances in which fund management is consulted. Further, pension funds' proxy guidelines are usually more explicit in policies pertaining to governance and consider such issues to be routine. Some proxies, however, are "red flagged" and sent to senior management—they include poison pills and other antitakeover measures; mergers and acquisitions; social responsibility issues; stock options; share dilution; executive compensation; and shareholder resolutions. One respondent (pension investor *E*) estimated his red-flagged proxies to account for 15–20 percent of proxies voted annually.

To mitigate the demands on time and staff of managing funds that in some cases hold stock in well over 1,000 firms, both pension and private mutual funds rely increasingly on proxy and corporate-governance consulting groups like Institutional Shareholder Services (ISS), the Investor Responsibility Research Center (IRRC), and the Council of Institutional Investors (CII). We summarize the function of the major proxy voting service and governance consulting groups in Appendix B.

All respondents agreed that because of the absence of a coordinating body, voting foreign proxies (as well as American Depositary Receipts [ADRs]) presents a host of problems. Among the most common are language barriers; timing in the receipt of proxies relative to the due date; unfamiliarity with foreign governance practices and attitudes; fewer shareholder-friendly regulatory or market practices; a voting-instruction process that is more cumbersome than processes employed for voting U.S. shares; and the reliance on external analysts and managers.[16]

Solutions to these and other foreign-proxy voting problems have been slow to materialize, but improvements are on the horizon. Pension investor *G* pointed to one example: in some countries, local law requires that a naturalized resident of the country hand-deliver ballots. To solve this and other related problems, this investor uses ISS, which in turn hires subcustodians in those countries

mandating such an arrangement. Other respondents also stated that they use ISS as a consultant for some foreign-proxy voting issues. Most respondents expressed a desire for standardization of voting procedures in foreign markets, and the hope that the work of such groups as the Organization for Economic Cooperation and Development (OECD) and the International Corporate Governance Network (ICGN) will hasten the progress.

Monitoring Governance or Performance? To motivate this second set of questions, we linked *corporate governance* to: the oversight role of the board of directors; board selection, composition, and compensation; mechanisms through which shareholders may communicate satisfaction or dissatisfaction with business strategy; senior executive compensation; and amendments to the corporate charter designed to influence the market for corporate control (for example, anti-takeover provisions). To fix ideas, we then defined *monitoring* the governance practices of firms in which our investors hold shares (or in which they are considering investment) as the sustained attempt to study, follow, or react to governance issues.

Most investment firms we interviewed delegate such monitoring duties to the proxy committee or proxy group and have codified their monitoring guidelines within their general proxy guidelines or, in the case of some activist pension funds, in separate policy statements on corporate governance. In a few cases, senior fund management handles monitoring, and in the case of investor *F*, a separate corporate-governance department handles the guidelines for and execution of monitoring.[17]

Most investors said they formulate and amend their own monitoring policies. Virtually all investors in our sample said they also consult or belong to one or more shareholder organizations that supply research data on firm performance and governance trends, recommend investment policies, and provide proxy advice to members. The most common groups with which investors consult or

in which they hold membership are the Council of Institutional Investors, the Investor Responsibility Research Center, and Institutional Shareholder Services. (See Appendix B.) Mutual-fund investors were particularly clear about the fact that they work independently, however, and that every situation is unique and therefore requires a unique response.

In an attempt to understand monitoring more completely, we asked respondents to distinguish, if appropriate, between "routine" and "special" monitoring, and to describe what would characterize each. From these discussions, we established that routine monitoring, for private mutual-fund investors, amounts essentially to monitoring for performance. Monitoring *governance* is considered special by the private mutual-fund investors and occurs generally only in cases of gross mismanagement.[18]

The investors with the clearest activist profiles (that is, the pension investors) generally feel that monitoring is both routine *and* special. It is important to note, however, that despite the framework of the discussion focusing on monitoring *governance*, the routine aspect of pension-investor monitoring is usually the use of screens that monitor *performance* first. Except in highly publicized cases of allegations of excessive executive compensation, beholden and dysfunctional boards, or fraud (for example, Disney, Archer Daniels Midland, or Cendant), it is generally only after firms are identified as troubled or as long-term underperformers that governance practices are given more than the standard, screen-based scrutiny. For example, in the case of pension investor *F*, a large and well-known activist fund, the first screen analyzes the three-year returns of all domestic equities in the portfolio and identifies the underperformers; the second screen is Stern-Stewart's economic-value-added (EVA); and the third is the IRRC's corporate-governance screen.

While these screens are applied to all domestic holdings, the size and diversity of the portfolios evidently force even the largest, most well-funded activist investors to

restrict their lists of targets for governance-oriented activism to those firms also showing poor performance over time. The essential difference, then, between private mutual-fund monitoring and pension-fund monitoring practices and philosophies appears to be this: whereas pension-fund investors are believers in good governance, private investors, while willing to entertain the notion that good governance matters, are not sufficiently convinced as to make lobbying for such practices worth the time and expense involved. Instead, as investor *B* put it, "[We] police the outer edges," focusing attention only on blatant governance problems and otherwise recognizing that different people and firms require different governance strategies. Most of the pension investors, by contrast, take the view of pension investor *F:*

> We have limited resources, so we focus on performance in our monitoring, but governance also adds value, especially when you're in the valley of your performance cycle. So, even if a firm is in good shape, we know they'll need the governance in place—we seek to make them integrate [our good-governance principles].

Even the most elaborate monitoring structure, however, is incomplete. As pension investor *G* explained, some governance problems (such as share dilution and repricing) do not show up in the screens—they arise only when proxies are distributed, which "forces us into reactive mode," as the investor scrambles to manage the fiduciary responsibility to make informed decisions on the issues contained in as many as 5,500 proxies (for the largest investors). This investor did point out, however, that revised SEC proxy rules have made it easier to solicit support for or against various proxy issues in cases where governance problems are not detected prior to the distribution of proxy statements.

Despite some pension investors' active philosophical commitment to the advancement of good-governance structures in public corporations, they agreed with other

survey participants that *performance* is the primary driver of the monitoring process. In fact, some investors consider performance a critical component of their fiduciary responsibility to shareholders, and in a few cases, fiduciary responsibility and performance are seen as inseparable concepts. Two investors (one private, one pension) also cited the Employee Retirement Income Security Act of 1974 (ERISA) and Department of Labor guidelines as having a shaping role in their investment-management and monitoring policies.

Directing the discussion toward the next set of questions—on activism—we asked investors if there were any instances wherein closer monitoring (regardless of type or provocation) could justifiably lead to a public confrontation with management. Two-thirds of those surveyed felt that public confrontation with a firm would be appropriate and justified if behind-the-scenes efforts failed to produce desired changes. Investors *A*, *E*, and *I*, however, were opposed to public confrontation under any circumstances. Of these, investors *E* and *I* cited a general preference for, as well as specific examples of, cases in which they benefited from another firm or firms' public action (the free-rider strategy). Investor *I* , one of several in our sample using outside managers, said "We prefer to participate [in such confrontations] as members of the independent investment manager's 'block' of shareholders." Regardless, public confrontation is generally regarded as a "last resort" tactic, with all investors agreeing that private negotiations are clearly preferable and better for all concerned parties.

Critical to any consideration of investor-firm communications is the interface between the investor and the CEO. Given the changing profile of firm ownership—from the many small shareholders to more concentrated holdings by institutional investors—it is reasonable to assume that investor-management relations have changed and will continue to do so. We asked our respondents about this progression.

Some investors surveyed believed that CEOs react to scrutiny of their firm's governance practices favorably but with some reservations. Most CEOs respond cordially to letters and phone calls from investors, and they demonstrate their commitment to a positive, open relationship with their large shareholders. Most private mutual-fund investors, however, were less inclined to believe that CEOs valued their communication. These investors observed that, despite the political wisdom of hearing the vocal activists out, CEOs regard such activists as wasters of both time and resources. Two of our pension-fund respondents also took this view of activists.

Pension-fund investors reported slightly more positive relations, which could be the result of longer-running and more frequent dialogues with the CEOs of their portfolio firms. As investor ***F*** noted, though, there is still considerable resistance to investor input among small-cap, mid-cap, and first-generation public companies—suggesting that CEOs at such firms often "haven't quite yet realized who owns the company."

When asked about the frequency of their voting with management, all but one of the pension investors in our survey said they would support management recommendations as a rule. This is somewhat counterintuitive, given the general impression that pension-fund investors are more inclined toward activism. Nevertheless, on this particular question, it was the private mutual-fund investors who were more clear: they stated that their monitoring and voting were handled case by case, and that they would not hesitate to vote against management, even if they intended to hold the shares for the long term. All investors in our sample agreed that there would be no hesitation in voting against bad governance (regardless of performance), and several cited specific issues, such as poison pills and share repricing—essentially anything that would limit shareholder rights or could hurt long-term value—as issues they would always vote against.

To quantify investors' assessments of the importance

of good governance, we asked interviewees to rank the relative importance of thirteen governance criteria on a scale of 1 to 5, with 1 being “not at all important” and 5 being “most important.” (These criteria can be seen in the survey instrument, included in Appendix C.) The investors considered board independence the most important of the governance criteria discussed. Private investors considered all these issues to be less important than did pension-fund investors—with the exception of anti-takeover measures, which private investors ranked higher on average than did pension-fund investors.

The discussion questions give the impression that most pension investors are either activists or free riders, but the responses to the governance-rating question show that the pension-fund investors are only slightly more likely than private investors to believe that a firm’s governance practices can be linked to share value. (Most pension funds are heavily indexed and passively managed.)

The average rating per criterion suggests further that neither pension investors nor private-investment firms believe that any of these criteria are absolutely critical to shareholder value, but this assumption can be somewhat misleading because of the point spread between the firms on certain questions. For example, while issues such as performance-based compensation for CEOs, anti-takeover provisions, and succession planning yielded relatively uniform and high scores across the pension-investor sample, other issues, such as board involvement in strategic planning, revealed significant divergence among investors. The variance is most clearly correlated with the investors’ relative positions on the scale of passive-active orientation—the private and passive pension investors are responsible for the low scores, and the activist pension investors for the high scores. This suggests that private and passive pension investors are fairly dismissive of governance issues (or at least are more likely to look first to performance), and that activist pension-fund investors (apparently the only kind

of activist) feel more strongly that governance can be linked directly to value.

Closing our section on monitoring and leading into our discussion of shareholder activism, we asked our respondents whether they held a basic definition of "good and acceptable corporate-governance practices." Although some investors from both private and pension-fund sectors did not offer any clearly articulated definition of good governance per se, several voiced pointed comments regarding investment policy and referred also to the public statements of key institutional investors as representative of their working philosophies. Investor *H*, for example, pointed to the following passages from her firm's proxy and governance-monitoring guidelines:

> The Fund's corporate governance policies subscribe to four basic principles: (1) the board of directors should be accountable to shareholders; (2) all shareholders should be treated equally; (3) shareholders should have the opportunity to vote on issues which would have a material financial impact upon a corporation; and (4) executive compensation should be a reflection of corporate performance.
>
> To monitor long-term performance, the [investor's] staff, with the assistance of outside consultants, developed a process to identify the long-term corporate underperformers within the Fund's stock portfolio. The type and visibility of communication between the Fund and identified underperformers is determined on a case-by-case basis. Effective communication will most likely be letter correspondence, but may include meetings with the board and attendance at annual shareholder meetings. The extent to which such communication is made public will depend on the particular circumstances. Some events may warrant publication of the Fund's concern while in other situations, it may prove more [beneficial] to have less public awareness.

Several other activist pension investors pointed to similar governance practices and ideals, but the state-

ments that are perhaps most representative of the evolving climate of corporate governance and activism come from the public record. In our interview and background-research processes, we considered the examples set by industry leaders such as the president of Fidelity Management & Research Company, Robert Pozen, and TIAA-CREF's chief executive officer, John Biggs. In a 1994 article for the *Harvard Business Review*, Pozen wrote what might be considered an authoritative statement of principles for corporate-governance and activism policy in the private mutual-fund industry. In Pozen's words:

> It is difficult to prove the financial benefits of good governance structures, such as the establishment of separate audit, compensation, and nominating committees composed entirely of independent directors, or shareholder rights to vote cumulatively or to call special shareholder meetings. If a company has a smart and strong CEO with appropriate compensation incentives, it may do well for years without these structures. But these structures are important safety valves when crises arise, when CEO succession is an issue, or when the business begins to go downhill. It is in the interest of institutional investors to make modest efforts toward promoting good governance structures as part of a long-term investment philosophy. (Pozen 1994, 145–46)

As counterparts to Pozen's Fidelity Management & Research Company in the mutual-fund industry, the pension investment sector has in TIAA-CREF and CalPERS two clear leaders in the development, dissemination, and adoption (by both institutional investors and corporations) of corporate-governance philosophy. All these investors, while diverse in customer orientation, have similar investment goals (that is, long-term value). They approach corporate governance with the conviction that good governance and the activism sometimes necessary to establish it add value for the shareholder. CREF's Biggs had this to say in a 1996 article for *Director's Monthly:*

> Since TIAA-CREF does not rely primarily on corporate America for its customers, the potential for direct retaliatory business influences on corporate activism does not limit TIAA-CREF's activities. In this respect, TIAA-CREF, though private, has some of the characteristics of public pension funds. . . .
>
> The major goal of our corporate assessment program is to review our portfolio companies' long-term performance and general corporate governance procedures. We are interested in answering this central question: Does the company have a vital and independent board performing a vigorous and challenging role in overseeing management's conduct of the business? . . .
>
> For the companies where we cannot answer "yes," we have an important role as a responsible owner. In most cases that role will involve gentle prodding, perhaps over several years, urging more independence, suggesting procedures to renew and revitalize a board, encouraging stronger evaluation practices, and perhaps even recommending a "business audit." . . .
>
> What are the payoffs to the pension plan participants of TIAA-CREF? . . . [T]he basic need of American companies for some form of shareholder monitoring is compelling. Certainly none of us want the Securities and Exchange Commission to do it. Our guiding motivation, however, must be the economic benefits to our TIAA-CREF participants. (Biggs 1996, 3–7)

These remarks frame perhaps the most contentious question in the contemporary discourse on corporate governance: Does shareholder activism add value? The private mutual-fund investors usually say "no"; the pension-fund investors often say "yes." In the final set of survey questions, we focused on this question.

Shareholder Activism. Having first explored the views of pension-fund investors and private mutual-fund investors on the question of shareholder activism in a general way, we then sought to determine their opinions more specifically. How might a shareholder determine the merits

of activism? What are the most effective activist strategies? If a shareholder believes that activism is unwarranted or too costly, what does he consider to be the most effective alternatives?

To begin, we tested our definitions of shareholder *action* and shareholder *activism* with our respondents and found some variance in the response. We defined an action to be a one-time, ad hoc response to an unforeseen problem, the communication of which may be private or public in nature, and activism to be a continuous and public effort to address both general and specific governance concerns with portfolio companies.

Among the private mutual-fund investors, there was disagreement on the definition of activism. One accepted the definition, stating that activism is not pursued on an "exception basis." Another defined activism more as we define action: "Activism is sporadic and goes beyond ordinary monitoring and voting." The third expressed general agreement with our definitions. For pension investors in our sample there was more agreement with our approach, particularly from those who call themselves activists.

We turned next to another rating-scale question, asking investors to rank three alternatives to activism—selling the shares, developing a checklist of good-governance practices to guide investment decisions, and conducting behind-the-scenes negotiations with management—on a scale of 1 to 5. One represented "very ineffective," 5 meant "very effective." Here the results confirmed that behind-the-scenes negotiations were clearly the most favored alternative to activism for virtually all respondents—including the activists. Checklist-based investment decisions were generally considered ineffective by both private mutual-fund investors and pension-fund investors. Selling the shares was also considered by most to be an ineffective alternative, although private mutual-fund investors gave it a slightly higher average rating than did the pension investors. The low scores for the "Wall Street walk" reflected in part the restrictions of indexing, which is more

prevalent among pension-fund investors; additionally, some pointed out that selling the shares would not send a clear message to the firm about the problem or problems that prompted the selling. There was a significant spread in the pension-fund responses both for selling the shares and for the use of governance checklists to guide investment, with one or two investors assigning each of these strategies much higher marks than the others did. Therefore, while the averages gave the appearance of consensus, practices were not uniform.

Next, we asked the investors to complete the following open-ended statement: "A qualified [or effective] institutional investor activist is. . . ." They were given the following list from which to select all appropriate answers: "(1) an expert on the firm's industry; (2) able to spend a significant amount of time monitoring the firm; (3) able to spend significant financial and human resources; (4) one who develops a checklist of good-governance practices to guide investment decisions." While time and staff resources were seen as universally necessary for effective activism, there were differences of opinion regarding how activism should be framed. Private investors believed that the action should be specific and should have an obvious link to shareholder value—it was otherwise considered too costly. Some pension-fund investors also agreed that activism should be focused if it is to be effective, but others, such as investors *D* and *F*, contended that "generic pressure" was helpful in keeping *all* publicly owned firms alert to the concerns of the investment community as a whole.

Apart from an investor's qualifications for activist behavior, there is the question of how well the issue itself qualifies for activism. At the heart of this determination is the cost-benefit analysis. Accordingly, we asked our respondents what they viewed as the benefits and costs of shareholder activism.

The private mutual-fund investors in our sample were in agreement that the only true benefit of activism is the advancement of shareholder value. As background,

Fidelity's Pozen (1994) has argued in the *Harvard Business Review*, for example, that it is very difficult to show a link between many forms of activism and the enhancement of shareholder value. Investor *C* pointed out that for her company, there were no clear, sweeping successes. There have been successes in some individual cases, she said, but the "institutionalization" of activism was not warranted.

Pension-fund investors were more willing to argue that activism works, although some were still unwilling to engage in it themselves. As investor *E* put it, "[We benefit] in a passive way by 'piggybacking' on the efforts of activist investors—we accomplish our goals without any publicity or manpower costs." This investor provides a working definition of a *free rider*, which the Pozen article defines as a major, unavoidable cost of activism, given the uncertain benefits. As we noted earlier, however, CREF's Biggs has written that the self-directed monitoring and activism undertaken by some funds help to keep the Securities and Exchange Commission at some remove from the shareholder-management relationship. He further points out that while free riders may benefit from CREF's activist work, "One might hope for support from other shareholders in egregious violations of governance principles, and we, after all, ride the coattails of other successful activist shareholder programs" (Biggs 1996, 8).

It appears, however, that pension-fund investors may have a different standard of proof for value added through activism, given the concerns this debate raises about the reliability of findings in statistical studies. In fact, paraphrasing the central point of MacAvoy and Millstein (1998), investor *G* said, "We are convinced—whether it is a measurable phenomenon or not—that most of our activism results in better shareholder value in the long run."

This raises the issue of activism's dependence on investment horizons for success. The private mutual-fund investors in our sample, representing a sizable portion of private mutual-fund assets held in the equities market,

must generally take a shorter-term point of view—despite the sizable percentage of assets managed as long-term investment (for example, retirement) accounts. Although there is general agreement in our sample (and most likely in the investment community at large) that long-term value is a central factor in investment decisions, the private mutual funds need to maintain necessary liquidity and hedge against fluctuation in the stock market, such as that seen in the latter half of 1998. Pension funds, though also compelled to manage liquidity carefully, often take a longer view of their relationships; some even think of them as quasi-permanent. In such long-term relationships, it is more plausible to suggest that activism is a useful strategy, although proving a causal relationship between activism and enhanced value becomes increasingly difficult as the interval between the action or activism and the increase in value grows longer.

On the "cost" side of the equation, all investors in our sample cite time and money as the most significant expenses of activism. Additionally—particularly in the case of private institutional investors—the necessary publicity that accompanies activism is viewed as negative and potentially damaging to business relationships, such as the maintenance of a retirement-fund program for a firm in which the fund company also owns voting stock. The financial cost is not to be underestimated; Pozen (1994, 143–44) argued that, in a contemporary fund market, with several thousand individual private mutual funds struggling to differentiate themselves for the customer, the costs of activism could make a fund's fee scale less competitive.

An additional cost pointed out by investor *E* is that activism can often interfere with or slow down strategic planning and other business decisions by the struggling firm, which, in some cases, can mean that the stock price will remain depressed for a longer period.[19] He suggests that it can be equally costly to shareholders, however, for management to offer too little resistance to activist demands. Following the logic of investor *E*, investor *G* ex-

pressed concern that in addition to the resource and business-interference costs of activism there are the reputational costs, whereby the activist may develop a track record for frequent and, perhaps, unfocused criticism, and thus lose the attention of management. When such a complaint is legitimate, poorly executed activism might be blocking improvements in performance and complicating the efforts of others to bring similar concerns to bear. But investor *D*, whose fund is quite active, pointed out that the pressure of activist publicity "can make the whole herd run faster."

In a related question, we asked investors whether they felt that activism could jeopardize good governance in the firm. Not surprisingly, the two most active investors in our sample believed that activism presents no real risks to good governance. Others, however, again raised concerns about the diversion of management attention from business decisionmaking. Indeed, investor *B* suggested that activism has provoked resistance from CEOs who are concerned that some institutional investors are attempting to micromanage their businesses. This inherent conflict—even if existing only in the minds of the CEOs—makes all negotiations between investors and management adversarial, which in turn makes them more costly to both parties.

To the extent that investors said activism could have positive effects, there was disagreement about what type of activism is most productive. Some felt that targeted or single-issue activism, which urges firms to adopt specific solutions for specific problems, works best. This is consistent with the shareholder action approach. Others felt strongly that a broad-based "set-of-issues" approach was better, reasoning that if governance is addressed in a more inclusive and constant sense, a firm is less likely to run into the kind of trouble that might provoke single-issue actions or activism.

Many answered that *both* types of activism were warranted and necessary at different times. Single-issue

activism "might garner more response," according to investor *E*, but broad activism is important to attain good governance "across the board." Investor *F* preferred a hybrid formulation, wherein a single set of issues would be addressed with the firm. For example, a concept such as *board independence* may be a single issue to some investors, but in the highly realized corporate-governance policies of investor *F*'s fund, board independence encompasses a set of issues.

We next asked investors which of the following forms of activism they had undertaken in the past year, and how often: voting in favor of a shareholder resolution; communicating a concern privately to a CEO or board; sponsoring a shareholder resolution; and publishing a public position statement regarding a conflict with a portfolio company. The results were again consistent with our findings and showed that activism is shunned by private investment firms and embraced by pension-fund investors. All investors reiterated their preference for handling concerns privately, but several indicated that they were ready to file resolutions and publicize their positions if they did not obtain the desired results through negotiations with management—and that they had taken numerous such actions this year and in years past. Most investors who had taken public action mentioned the same cases (for example, a company's poison pill, or an executive-compensation dispute with a company).

Asked if activism was generally a prudent and effective strategy, four investors said "no" and six said "yes." Private investors were unanimous in their rejection of activism, as was investor *I*. But investor *C*, who represents a large private fund family, did make an allowance for case-by-case analysis to determine proper strategy. Investor *B* stated that, with the exception of the specialized, socially responsible funds, he did not imagine that customers would be willing to pay the higher management fees required to underwrite activism, particularly since it is so difficult to measure the enhancement of fund perfor-

mance resulting from such a management strategy. The remaining pension investors all thought that activism is a good strategy for investors, though investor *E* again noted his fund's policy of passive support, or free riding, for such policies.

In discussing the conceptual successes and failures of activism, investors had much to say. Members of both pension-fund and private mutual-fund investment concerns pointed out that the cumulative effect of high-profile activism has been to raise the consciousness of management and the general skill level in addressing governance issues and some specific strategic matters, such as responding to investors concerned with social-responsibility criteria. The accountability of the board of directors to the shareholders has also improved. As investor *G* put it, "We finally have their attention," adding, however, that " the grading of companies undertaken by organizations like CalPERS has failed to achieve much for shareholder value." This again raises the specter of reputational costs to the activist, and the broader concern that such public-relations damage weakens all activists' causes. This awareness has improved communication between investors and management, which can often result in the resolution of conflict behind closed doors—a relatively cheap route to increasing shareholder value. As investor *B* put it, "Making it the personal obligation of the CEO and/or CFO to make regular visits to all the big institutional investors is the best way to achieve good governance—it's 'accountability.'"

Investors believed that other governance concerns had also improved, including board independence and organization. Investor *B* pointed out that, "In general, it is the board of directors that is most important in disciplining bad governance," which may be more likely to happen as board independence rises. Additionally, investors cited the moderation of company positions on takeover bids and anti-takeover measures as a success of activism, though a few pointed out that some states, such as Pennsylvania and Delaware, have very strict anti-takeover laws, which

are beyond the reach of activists. Firms averse to takeover often incorporate in those states for protection. Investor *E* suggested that activism, while sometimes pushing these bids forward, can also create a bunker mentality, further entrench management, and possibly depress shareholder value.

Finally, investor *H* pointed to the success of activism in forcing companies to link executive pay to performance through stock options and stock-based compensation. At the time of the interview (May 1998), she added that this pay-performance link was getting out of hand, because of the strength of the economy. (In the subsequent months, however, as share values fell in the United States, a new problem arose: option-share repricing.) All the investors interviewed in our study cited this practice as troublesome and worthy of some form of protest, whether by informal conference or formal activism.

Despite the successes, investors also felt that activism had failed to deliver in a number of fundamental areas. Some suggested that activism has in some conspicuous cases become an end in itself rather than a means, and that it is promoting the development of a cottage industry of consultants who are not necessarily doing anything to improve shareholder value.

Others said that, in general, the link between activism and increases in shareholder value is unproven. Investor *I*, for example, had particularly strong feelings: "Nothing ever comes out of activism—CalPERS and New York [pension funds] will make a brief splash in the trade papers initially, but I never see any meaningful follow-up, or evidence that the activism has resulted in increased value for shareholders." Finally, investor *B* asserted that in many cases a firm will solicit his fund's vote during behind-the-scenes talks but will then drop the fund's concerns as soon as it feels it has secured the necessary votes. Investor *J* added that "the vast majority of shareholder proposals don't receive board support, and even those that do are often not enforced."

Investors were also divided on the question of regulating activism. Private mutual-fund investors are generally opposed to regulation, but one was willing to entertain the idea, citing the "self-interest[ed]" motives of some activists. Another suggested she was not "dead-set against them," but wondered "who would the regulators be, and could we trust them?"

Some of the pension-fund investors—including one activist—were more open to the notion of some regulation, to prevent situations such as the possible takeover of a firm by an institutional investor or investors; to limit activism by special-interest groups (for example, labor unions) that undermines shareholder value; or to limit the number of times a shareholder resolution can be resubmitted. At the same time, most of the investors qualified their answers by pointing out that any regulation beyond what is currently mandated by the SEC would most likely do more harm than good, possibly limit the activity of "legitimate activists," and in the end impede business and threaten shareholder value. Most holding this point of view pointed to state-level anti-takeover provisions, such as those that prevail in Pennsylvania (which figured prominently in the unsuccessful hostile-takeover bid for AMP Inc. by AlliedSignal).

Our penultimate question asked for opinions on what effect—if any—activism or the threat thereof has on the functional or strategic parameters of CEO decisionmaking. (As examples, we offered corporate financial policy, mergers and acquisitions, research and development, and fixed capital investment.) Investor *B* said the effect is marginal and contained to governance issues, but investor *A* believed the threat or engagement of activism constitutes a significant part of a CEO's calculations, which he says is distracting, wastes resources, and forces time-consuming distortions of management decisions.

Of the four criteria, mergers and acquisitions was the only category in which the pension-fund investors believed shareholder activism might have a moderate to

significant effect on CEO decisionmaking. Corporate-financial policy would most likely show only slight changes in the face of activism or a credible threat thereof, they said. None of our respondents believed that R&D or fixed-capital investment would be changed noticeably by shareholder activism.

To close the survey, we asked investors to rate alternatives to shareholder activism for monitoring governance and disciplining departures from good governance, with 1 being "not at all important" and 5 "most important." The alternatives being rated are the relative influences carried by the following: large individual shareholders; boards of directors; capital markets; and competitors within the firm's industry.

Among most respondents, boards of directors are considered to be the most effective in disciplining departures from good governance, but the broad range of responses on this and other criteria shows that there is still much to be learned about how to conceive, implement, and enforce good governance practices. And to some extent, with the present rules, investors will always be limited in recourse.

Presumably, boards of directors are effective governance watchdogs when they are largely or fully independent, and perhaps when the positions of chief executive officer and chairman of the board are separated. All respondents indicated that they believed the board's primary role is to police the firm's governance, but the discrepancy in their rankings reflects a feeling that the boards in many portfolio companies remain insufficiently independent.

Most agreed that, although large individual shareholders can sometimes discipline bad governance, such discipline is much harder to accomplish alone. Furthermore, investors *A* and *C* both raised the concern that the agenda of one powerful private shareholder may not be sufficiently objective for his or her activism to be in the interests of all shareholders. This answer, of course, begs

the question of what other motive—apart from maximizing the value of shares—the large shareholder would have for undertaking activism. Additionally, although capital markets were generally viewed as important for competition in disciplining bad governance, there was less consensus about a role for product-market competition.

4
Conclusions and Directions for Research

Although most institutional investors do not seek to engage in activism per se, at one time or another they are critical of the performance or corporate-governance policies of the firms in their portfolios. Pension-fund investors—perhaps because their investments are heavily indexed, or because they are generally free from conflicts of interest with firms in their portfolios—are usually willing to conduct public activism if they believe it will boost performance. And they believe this more frequently than do private mutual-fund investors.

Private firms in our sample stated clearly that activism in their firms is extremely limited and that they prefer to resolve their issues behind the scenes. It may be, however, that their membership in and consultation with proxy and governance research firms and network groups such as Institutional Shareholder Services (ISS) and the Council of Institutional Investors (CII) allow private mutual-fund investors to address their concerns as behind-the-scenes activists. The function of CII, in particular, is to maintain a growing network of institutional investors whose purpose is to bring pressure and influence to bear on underperforming firms. In essence, CII is an activist collective, wherein no individual institution is forced to stand alone in conflict with a portfolio firm. Given the substantial costs (in time, money, and unwanted publicity) required to mount an activist campaign, such collec-

tive activism is likely to be the wave of the future for institutional investors generally.

There appears at first glance to be a wide disparity between practitioners' evaluations of institutional-investor activism in corporate governance and the views of legal and financial scholars. Although we agree that institutional investors' concerns over the corporate-governance practices of portfolio companies are a good thing, compelling empirical evidence linking investor activism with performance is lacking.

Based on interviews with senior executives of institutional investors, we argue that this disparity is less clear than it might appear at first glance. Many institutional investors themselves, while expressing agreement about the importance for corporate performance of shareholder rights, effective boards of directors, and efficient CEO compensation and succession, are skeptical of institutional-investor activism. Indeed, most investors stress monitoring and activism related to measures of performance and rarely to the issue of governance per se.

These results do not indicate that concerns over corporate-governance practices are irrelevant. Quite the contrary, all the institutional investors we interviewed expressed detailed and well-researched views on corporate governance. Our interview findings suggest the desirability of reorienting academic inquiry and analysis in three areas: (1) the link between boards of directors and performance, (2) the investment decisions of institutional investors, and (3) the link between institutional ownership and variables connected to firm performance.

Practitioners often stress the role of boards of directors in decisionmaking when firms are in trouble (see, for example, the discussion in MacAvoy and Millstein 1998). The notion that the value of an independent board is high when a firm or its industry is in trouble calls into question a research strategy of estimating a linear relationship between firm performance and director composition.

Such a strategy has already been criticized because of the endogeneity of director composition (see, for example, Agrawal and Knoeber 1996 and Bhagat and Black 1998), but the point raised by practitioners also emphasizes nonlinearity in any relationship between board independence and performance.[20]

In this regard, the model by Hermalin and Weisbach (1998) of endogenously chosen boards and monitoring is promising. In that model, board independence is most important in periods of poor performance and when the CEO's bargaining power is weak. This line of inquiry suggests at least two promising strategies for empirical analysis: (1) an emphasis on the determinants of board composition and board independence (compare the examination of managerial ownership in Himmelberg, Hubbard, and Palia 1999); and (2) case studies of cross-firm variation (between independent-board and non-independent-board firms) in CEO turnover and performance following an adverse shock to the industry. The strong statements by the institutional-investor representatives we interviewed about the role of the board suggest the fruitfulness of such research.

A second promising area of inquiry is the link between institutional ownership and corporate performance. Some analysts have concluded from empirical examination of firm data that higher levels of institutional ownership are associated with higher levels of corporate performance. Important questions remain, however. Following the intuition of Himmelberg, Hubbard, and Palia (1999) and Gompers and Metrick (1998), for example, might causality go the other way? Do institutional investors choose certain types of equities (by capitalization, turnover, market-to-book ratios, momentum, and so forth)? Is this choice related to security characteristics or governance characteristics? Does the institutional ownership–corporate performance link vary between "index stocks" (for which the institutional-ownership choice is arguably more exogenous) and "non-index stocks"?

A third line of empirical research suggested by the institutional investors' emphasis on shareholder returns rather than on the monitoring of particular management activities or decisions per se would focus on links between dividend policy and institutional ownership. For example, dividend payments might be used as a signaling device to attract institutional owners who "monitor" the firm (as in Allen, Bernardo, and Welch 1998). Alternatively, institutional owners may push for higher dividend payout to mitigate agency costs, thereby improving firm performance (see, for example, Bond, Meghir, and Windmeijer 1998).

Appendix A: Proxy Guidelines

All survey participants' charters or proxy guidelines provide for the standardization of the voting mechanism and its administrative body (for example, the proxy committee). The maximization of shareholder value, tied inextricably to most investors' operative definition of "fiduciary responsibility," is the primary determinant of proxy-voting guidelines for all investors in our sample. In these respects, there is little variance among investors, regardless of private mutual-fund or pension-fund orientations.

Most investors in our sample state in their guidelines (or in their interviews) that they will vote with management recommendations on routine issues, so long as investor confidence in management remains and so long as such recommendations do not deviate from value-maximization strategy or violate voting guidelines concerning shareholder rights (broadly conceived to include anti-takeover provisions, such as poison pills), executive compensation (including stock option and other stock-related plans), and board composition and compensation (that is, outside versus inside directors, committee structure, classification questions, compensation structure, and so forth). All reserve the right to deviate from both management recommendations and internal voting guidelines whenever such action is deemed necessary to protect long-term shareholder value.

The primary areas of difference between the voting

guidelines of private mutual-fund and pension-fund investors are in the style and degree to which shareholder-rights protections are realized in policy guidelines. Despite the shared goal of fiduciary responsibility (to maximize shareholder value), in some cases the pension-fund investors go to greater lengths outlining their policies concerning shareholder rights and governance issues in philosophical, as well as practical, terms. Indeed, some in our pension-fund sample generate and publish dedicated documents concerning corporate-governance policies. In these documents, investors set forth principles concerning such issues as those mentioned above, as well as CEO performance evaluation instruments, strategic (business) planning, and social responsibility. Additionally, clear emphasis is given to the notion that the long-term investor-firm relationship makes it imperative to have effective, independent boards, devoid of entrenchment provisions.

In contrast, the guidelines of our private mutual-fund investors tend to be relatively circumspect and make specific policy issues, such as stock-option compensation plans and anti-takeover measures, the primary concern. In general, policies regarding stock options as compensation mirror those of pension investors: share dilution should not exceed 10 percent for firms with large market capitalization; the board or compensation committee may not amend such plans without shareholder approval; repricing of options should be a solution of last resort and approved only by a compensation committee of directors wholly independent of the firm. Shareholder rights plans are considered on a case-by-case basis and supported only in cases of a move by a board to entrench or of a link to a specific business plan deemed likely to enhance value. These investors also tend to support shareholder resolutions requesting that shareholders be given the power to approve such rights plans.

Finally, all investors have policies, either written into their guidelines or more informally, on investor-firm communications through which disputes can be resolved.

While all investors are eager to resolve conflicts behind the scenes, pension-fund investors provide, in their voting or governance, guidelines for more active engagement with firms, whereas private investors favor giving management somewhat broader latitude before voting against or engaging it in discussion.

Appendix B: Voting Services and Corporate-Governance Consultants

Institutional Shareholder Services (ISS): ISS, a for-profit unit of Thomson Financial Services, provides proxy advice, research on proxy and governance issues, voting agent services, and voting recommendations to approximately 500 institutional investors. ISS carries out research on 8,500 U.S. companies and 7,500 companies in 40 foreign markets, and, in addition to its 130 domestic staff, has alliances with several similar European organizations to augment foreign issues research.

An examination of the ISS Website reveals that, through press releases and business and mainstream media coverage, ISS is also, in a sense, an activist organization, taking numerous public positions on high-profile proxy issues and governance-related concerns. Membership in ISS may, then, allow a "reticent" private institution to participate in activism without any of the costs (time, money, unwanted publicity) that make it unattractive as a direct tactic. The costs to ISS are inconsequential, because the research and its dissemination are at the heart of its mission, because it is not beholden to any of the firms under scrutiny, and because the operation is financed by membership and service fees.

Council of Institutional Investors (CII): CII is a network of large corporate, Taft-Hartley, and public-pension

funds that joined forces in 1985 to monitor governance issues and, in accordance with their fiduciary duties, take action where and when necessary to protect and enhance the value and returns on investments of member funds. Membership now includes more than 100 pension funds, with combined assets of more than $1 trillion.

Although the council does not offer meeting-specific analyses and general membership is restricted to employee-benefit funds, the CII offers other levels of membership (such as the "educational sustainer," which is open to all and includes many fund managers). It provides a host of research and legal services, and it publishes regular issue-specific monographs and lists of underperforming firms and boards. Meetings are held semiannually, with quarterly executive committee meetings and issue-specific meetings held on an ad hoc basis.

Investor Responsibility Research Center (IRRC): IRRC is a private, nonprofit organization that provides electronic proxy voting services and assorted governance, foreign equity, and social-issue consulting services. In most observable respects it is very similar to ISS, although it does not offer voting recommendations.

Appendix C: Survey Questions for Institutional Representatives and Managers

Objective: The objective of this survey is to investigate the various methods employed by a sample of institutional investors to carry out their fiduciary and other responsibilities in the area of corporate governance. It is also designed to allow institutional investors to express an opinion on how best to execute their responsibilities in that area.

The expected outcome of this survey is to report on prevailing current practices, to identify major positive (and, if necessary, negative) approaches, and to propose a methodology that institutional investors could adopt in the area of corporate governance.

Survey Section 1: To determine the proper administrative approaches to dealing with proxy statements and voting

We would thus first like to explore your internal procedures and practices as they relate to voting the shares that your funds own.

- Do you have detailed and explicit internal proxy voting guidelines? ❑ Yes ❑ No

  Could you share them with us?

- If no detailed voting guidelines exist, are you contemplating putting them in place? ❑ Yes ❑ No

  How will you go about introducing them?

  What will be your model?

- How long have your procedures been in place?
  ❑ Less than 1 year
  ❑ 1–2 years
  ❑ 2–5 years
  ❑ > 5 years

  Who initiated/initiates them?

  How are policy changes or updates handled?

- Who is responsible for implementing the procedures?
  ____________________________ (Title)

- Do fund managers determine how shares should be voted? ❑ Yes ❑ No

  Do overall institutional corporate or general managers?
  ❑ Yes ❑ No

  If both groups participate, what types of issues are "red-flagged" and sent directly to senior management? (Explain.)

- Recordkeeping: Is there a central repository for receipt of proxies and for completing them?
  ❑ Yes (Explain.)

  ❑ No (Explain.)

- Is there internal coordination for the voting of shares of the same firm across all funds that own shares of that firm?
  ❑ Yes (How?)

  ❑ No

- Are there any special complications in voting proxies for shares in foreign firms?
  ❑ Yes (Explain.)

  ❑ No

- Any other aspect of this topic on which you would like to offer observations?

Survey Section 2: To determine how institutional investors could or should best monitor the governance issues in the companies in which they are invested

One problem with investigations of “corporate governance” is that good corporate governance mechanisms are often difficult to define. We suggest that you think about corporate governance as referring to a set of interwoven issues including the oversight role of the board of directors; board selection, composition, and compensation; mechanisms through which shareholders may communicate satisfaction or dissatisfaction with business strategy; senior executive compensation; and amendments to the corporate character designed to influence the market for corporate control (for example, anti-takeover provisions). With this concept of corporate governance in mind, we would like to ask you about the ways in which you attempt to study, follow, or react to governance issues in firms in which you own shares. For ease of exposition, we call the entire process “monitoring.”

- Do you agree with the above definition of monitoring?
  ❑ Yes ❑ No

  If not, how would *you* define monitoring?

- Is monitoring—as defined above, or by your definition—a “routine” practice, or a “special” response to troubling developments in a given firm, or both?
  ❑ Routine (Please elaborate.)

  ❑ Special (Please elaborate.)

  ❑ Both (Please elaborate.)

- Is your monitoring legally driven by your fiduciary responsibility, or is it performance driven?
  - ❑ Primarily driven by fiduciary responsibility
  - ❑ Primarily driven by performance

  Please explain answer.

- Do you have internal procedures used to monitor governance?
  - ❑ Yes (What are they?)
  - ❑ No

- At what level of the organization does this monitoring take place?
  - ❑ Proxy committee
  - ❑ Senior management
  - ❑ Other (Explain.)

- Are such monitoring procedures in writing?

  ❑ Yes ❑ No

  Who is responsible for determining and/or changing them?

  ____(Title)

- Do you determine your monitoring priorities independent of the views of other similarly situated institutional investors?
  - ❑ Yes (Explain.)
  - ❑ No (Explain.)

- Are you involved in any formal or informal organization that coordinates monitoring?
  - ❑ Yes (Which?)
  - ❑ No

- Are there any instances where closer monitoring by large shareholders justifiably leads to a "confrontation" (that is, public disagreement with management)?
  - ❑ Yes (What are they?)
  - ❑ No
- Do good financial performance and returns generally overshadow any other governance issue?
  - ❑ Yes (Explain.)
  - ❑ No (Explain.)
- How do you believe CEOs generally react to closer scrutiny of corporate governance by large institutional shareholders? (Please elaborate.)
  - ❑ Favorably
  - ❑ Favorably, with reservation
  - ❑ Unfavorably
  - ❑ Other (Explain.)
- Do you, as a rule, tend to support management recommendations?
  - ❑ Yes (Explain.)
  - ❑ No (Explain.)
  - ❑ In which areas do you tend to make exceptions?

- Looking at some of our definitions of corporate governance issues, would you share with us the level of importance you assign to:

	Not at All Important	Of Minor Importance	Somewhat Important	Of Major Importance	Most Important
Size of board?	1	2	3	4	5
Age of board members?	1	2	3	4	5
Other activities of board members?	1	2	3	4	5
Board composition?	1	2	3	4	5
Institutional representatives on board?	1	2	3	4	5
Independence of board members?	1	2	3	4	5
Separation of chairman and chief executive officer positions?	1	2	3	4	5
"Lead director" position?	1	2	3	4	5
Involvement by the board in strategic planning?	1	2	3	4	5
Reasonable performance-based compensation for board members?	1	2	3	4	5
Performance-based compensation for CEOs?	1	2	3	4	5
CEO succession planning?	1	2	3	4	5
"Poison pills" and other anti-takeover provisions?	1	2	3	4	5
Other specific issues? (Explain.)	1	2	3	4	5

- Overall, do you have a definition of good and acceptable corporate governance practices? ❑ Yes ❑ No

  If "Yes," what is it?

  Would you agree, disagree, or add to any of the issues we have raised in the above chart?

Survey Section 3: To determine whether highly publicized "activism" by institutional investors is a proper and correct approach for institutional investors as a matter of policy and strategy

Indeed, many commentators in business and academia have urged institutional investors to engage in "shareholder action" on an ad hoc basis or "activism," a continuous exercise of a concerted effort to address governance issues.

- Do you agree with this definition of "activism"?
  ❑ Yes ❑ No

  If not, how would *you* define activism?

- Please rank the effectiveness of the following alternatives to "activism" by institutional investors, presuming the goal is shareholder value maximization:

	Very Ineffective	Ineffective	Somewhat Effective	Effective	Very Effective
Selling shares	1	2	3	4	5
Developing a checklist of good governance practices to guide investment decisions	1	2	3	4	5
Behind-the-scenes negotiation with management	1	2	3	4	5
Other strategies (Explain.)	1	2	3	4	5

- A qualified institutional investor activist is:
  - ❑ An expert on the firm's industry
  - ❑ Able to spend a significant amount of time monitoring the firm
  - ❑ Able to spend significant financial and human resources
  - ❑ One who develops a checklist of good governance practices to guide investment decisions
  - ❑ Other (Please specify.)

- What are the *benefits* of activism by institutional investors (in time, money, publicity, or otherwise)?

- What are the *costs* of activism (in time, money, publicity, or otherwise)?

- Are there any risks to good governance from an activist approach?
  - ❑ Yes (Explain.)
  - ❑ No (Explain.)

- In some cases, one sees activism by institutional investors that covers a set of issues; in others, activism is focused on a single issue. To the extent that you find activism a positive force, which type do you consider to be the most effective?
  - ❑ Set of issues (Why?)
  - ❑ Single issue (Why?)

- In the past year, which of the following forms of activism has your firm undertaken? (Please indicate how many times you've taken the action.)
  - ❑ Voted in favor of a shareholder resolution
  - ❑ Communicated a concern privately to CEO and/or board
  - ❑ Sponsored a shareholder resolution
  - ❑ Published a public position statement on a conflict with a portfolio company
  - ❑ Other (Explain.)

- Overall, is activism a prudent and effective strategy for institutional investors?
  - ❑ Yes (Explain.)

  - ❑ No (Explain.)

- What in your judgment are the most notable successes and failures of activism (conceptually, as opposed to specific company examples)?

- Should there be regulatory limits to institutional shareholder activism?
  - ❑ Yes (Explain.)

  - ❑ No (Explain.)

- Please indicate below to what degree you believe activism or potential activism by institutional shareholders changes the functional and/or strategic parameters of CEO decisionmaking:

	No Measurable Change	Slight Change	Moderate Change	Significant Change	No Opinion
Corporate financial policy	1	2	3	4	5
Mergers and acquisitions	1	2	3	4	5
R & D	1	2	3	4	5
Fixed capital investment	1	2	3	4	5
Other (Explain.)	1	2	3	4	5

- Based on your thoughts about the effectiveness of monitoring by institutional investors, please rate the following alternatives in terms of their relative importance to monitoring corporate governance and disciplining departures from good governance practices.

	Not at All Important	Of Minor Importance	Somewhat Important	Of Major Importance	Most Important
Large individual shareholders	1	2	3	4	5
Board of directors	1	2	3	4	5
Capital markets	1	2	3	4	5
Discipline from competitors in the firm's industry	1	2	3	4	5

Notes

1. In 1950, 89 percent of the $146 billion of U.S. corporate equities outstanding was held directly by households; 2.3 percent was held through mutual funds; 4 percent was held by insurance companies and pension funds. By 1970, households held about 75 percent of the $906.2 billion of U.S. equities, versus about 5 percent held in mutual funds and about 12 percent in insurance and pension funds. The allocation of $1,513.8 billion in U.S. equities in 1980 was spread across households (59 percent), mutual funds (3 percent), and insurance and pension funds (23 percent). Holdings by institutional investors rose substantially during the late 1980s and early 1990s. By 1992, households directly held 54 percent of equities, while mutual funds held about 7 percent and insurance and pension funds held 28 percent. Finally, at the end of 1997, households directly held 43 percent, while mutual funds held about 16 percent and insurance and pension funds held about 30 percent. (These calculations were made using data from the Federal Reserve's *Flow of Funds Account*, various years.)

2. Rule 14a-8 excludes, for example, subjects that deal with the "ordinary business" of the company, as well as debate over nominations for the board of directors.

3. There may also be shareholder proposals pertaining to social or economic issues.

4. Costs of proposal development and free-rider problems in principle led activists to emphasize structural and process issues (see, for example, Black 1992). Our interviews support this intuition.

5. Formal coordination beyond ISS is relatively rare because of regulatory constraints (see Black 1993 and Coffee 1994).

6. For a more detailed description of this argument, see Stigler and Friedland 1983, Demsetz and Lehn 1985, and Himmelberg, Hubbard, and Palia 1999.

7. See, for example, Wahal and McConnell 1997 or Gompers and Metrick 1998.

8. See MacAvoy and Millstein 1998.

9. These interviews took place between October 1997 and August 1998.

10. The complete survey instrument is attached in Appendix C.

11. By using personal interviews with senior officials, our goal was to obtain more reliable results than those that could have been expected from mail surveys, which are all too often either discarded or left to a less senior administrator to complete.

12. This figure reflects one corporate pension fund; one private union or professional pension fund; three bellwether private mutual funds; and five public or state pension funds.

13. In the interviews, we drew a distinction between shareholder *action* and shareholder *activism*. Shareholder action is characterized by an ad hoc response to an unforeseen, isolated problem arising in a portfolio firm, wherein the investor believes immediate and direct attention is required. This may take the form of a behind-the-scenes dialogue with management or of a one-time public airing of concerns. Shareholder activism is, by contrast, a continuing and concerted effort to address matters of concern to the investor with management, and it takes place in a formal, public setting. An example is the practice of screening portfolio firms on performance and governance variables, assembling a list of firms failing the investor's standards, and publicizing the list in the mainstream media as a means of motivating boards and management to address previously ignored shareholder concerns.

14. In the case of private investor *C*, guidelines have been in place since 1963, owing to *C's* early emergence as a leading special-interest investor. The special interest is social responsibility.

15. According to investor *D*'s governance policy statement, for example, a board of directors' fiduciary responsibility is to ensure that the corporate environment is one of "strong internal controls, fiscal accountability, [and] high ethical standards," and that the firm is in "compliance with applicable laws and regulations." Procedures must be in place to discipline violations of these resolutions. To further ensure that fiduciary duty is carried out, the board should "appoint an audit committee composed exclusively of outside, independent directors"; devise and install a review process to ensure proper allocation of corporate resources; and provide a clear mechanism by which large shareholders can communicate concerns directly with the board.

16. Some respondents pointed out that the Department of Labor is pressing investors to vote *all* foreign proxies, and also that ERISA guidelines are beginning to address foreign proxy issues. But in cases where information is incomplete or the ballots are not made available in time, or where the necessary staff and resources are lacking, some investors will abstain from voting problematic foreign proxies.

17. A few of the public retirement systems do not handle their monitoring activities directly, however, because their holdings are managed by a third party. Of these, most generally supply the external managers with investment and voting guidelines. The managers are instructed to devise their monitoring guidelines on the basis of overall investment and management rules. For example, if a fund is "socially responsible," its investment rules may require that managers monitor the advertising policies of tobacco-product firms in the portfolio, to make sure that the firms are not targeting minors in their advertising.

18. Moreover, the private mutual-fund investors we interviewed were essentially unanimous in stating that monitoring the governance process was a relatively minor facet of their overall investment management, and far less organized than was the case for the pension investors. Investor *B* pointed out that "there are different ways to run a company; we're not inclined to impose a formula." Pension-fund investors,

however, believe that monitoring is of major importance, regardless of performance, and they observe clearly delineated guidelines for it. This monitoring is generally based on an IRRC or similar governance-specific screen. Two large and traditionally activist investors (*F* and *G*) compile annual lists of troubled companies targeted for intensified monitoring or activism.

19. The way in which this point is framed suggests again that firms subject to shareholder activism are singled out because of poor performance, above and beyond other considerations, including problematic governance policies.

20. For example, Brickley, Coles, and Terry (1994) find that, while stock market reactions to the adoption of poison-pill defenses are significant if the firm has only a minority of independent directors, the reaction is statistically positive when the majority of directors is independent. In addition, Weisbach (1988) finds that the correspondence between CEO turnover and firm performance is greater in firms with a larger proportion of outside directors.

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