Working Paper 13/01

INSTITUTIONAL INVESTORS, CORPORATE GOVERNANCE AND PENSION FUNDS

Michela Scatigna[♠]

[♠] CeRP
Via Real Collegio, 30
10024 Moncalieri (Turin)
Tel.: +39.011.6476525
Fax: +39.011.6403680
E-mail: scatigna@cerp.unito.it

ABSTRACT

This paper presents an analysis on how the expected development of pension funds in Italy will contribute to enhance corporate governance .

The existing evidence on this issue comes mainly from the Anglo Saxon countries but it does not show unequivocal effectiveness of activism on firm performance. In Italy the current design of pension funds governance substantially mirrors that of UK, where pension funds as well as life insurance companies show a preference for passivity instead of activism. Evidence from countries such as Japan and Israel, that are similar to Italy from a corporate governance point of view, is also included in order to better understand the perspectives for Italy.

All in all, the private funds industry seems to be characterized by several group-affiliated institutional investors whose investment policy is likely to be plagued by conflicts of interest similar to those existing in Japan and Israel. Supervision by market authorities and performance-related managerial compensation would help mitigating this problem.

I am especially grateful to Giovanna Nicodano for insightful and constructive feedback. I also wish to thank Elsa Fornero for the opportunity she offered me to develop this paper.

1. Introduction

Institutional investors and especially pension funds are expected to grow rapidly in many industrialized countries that are going to rely more on private funded schemes. One possible spillover effect will be the participation of pension funds in corporate governance issues.

The role of institutional investors in corporate governance has been studied largely in the USA. This country presents indeed the largest institutions, the most developed financial markets, and the highest grade of contestability of firm ownership.

Institutional investors as large shareholders are viewed as a solution to the corporate governance problem as they could actively pressure managers to force fundamental changes in the firm. When fund managers are dissatisfied with firm performance they can choose to *vote with their feet* (or follow the "Wall Street Rule"), by selling their shares. Alternatively they can invest in monitoring and *voice* their dissatisfaction taking an active role in the decision making process. The extent to which institutions choose to vote with their feet instead of activism has been related to their preference for liquidity instead of control.

On the one hand, market liquidity may suffer from blockholders' monitoring. Bhide (1993) for example, argues that liquid stock markets are a barrier for effective governance, i.e. it is too easy for institutions to vote with their feet. In his view, stock liquidity discourages internal monitoring by reducing the cost of selling the stake of unhappy shareholders, thus he concludes that "the benefits of stock market liquidity must be weighted against the costs of impaired corporate governance". On the other hand, Maug (1998) finds an unambiguously positive relation between market liquidity and large shareholder activism. He develops a model of a firm with a large shareholder and a continuum of small shareholders who are subject to correlated liquidity shocks. In equilibrium, the large shareholder has a stake that is not large enough to cover the monitoring costs, so he would intervene only if the price that he has to pay to increase his stake does not reflect the improvements that he would get from the monitoring activity. The main result achieved by this model is that the liquidity shocks increase the probability of intervention by the large shareholder.

the preferred behaviour adopted by institutional investors, and how effective it is on corporate governance, has been mainly addressed from an empirical point of view. The effects of "voting with their feet", have been examined in a recent work by Parrino, Sias and Starks (2000). They study the influence of declines in institutional ownership on CEO turnover using data of 583 CEO turnover at large public corporations over the years 1982-1993 in the US. They find that there is no significant change in the ownership by institutional investors in the two years before and after voluntary CEO turnover, whilst there is a decrease in institutional ownership in the two years prior to forced turnover. As a result, voting with feet by institutional investors affects board decisions forcing CEO turnover. Further, the induced changes of CEO following a sell-off by institutions is also associated with a greater likelihood that an outsider is appointed to replace the fired CEO. This evidence supports the hypothesis that institutional selling has a non negligible impact on the board of directors decision making process and ultimately can affect corporate governance.

Institutional investor activism presents a larger amount of evidence with respect to voting with feet, but the results of these studies are at best mixed. Activism seems to have no significant effects if conducted through proxy fights, whilst direct negotiations effectively affect firm performance.

In what follows, I will first survey the available empirical evidence concerning the US and the UK. After that, I will examine the situation of activism in Italy and in other two countries that can be considered similar to Italy from a corporate governance point of view, namely Japan and Israel.

2. Institutional Investors Activism and Dispersed Ownership

The evidence coming from the Anglo Saxon countries is the most important source of information about the role that institutional investors can play in corporate governance. Indeed, these investors have become the majority owners of large corporations; in the US, they own 50% of the top fifty companies, and the top twenty pension funds own 8% of the stocks of the ten largest companies. The emergence of institutional activism in US corporate governance occurred when dissatisfaction with the takeover mechanism as a way to discipline management increased, leading large shareholders to seek new means to exert corporate control.

Activism can be distinguished by kind of institutional investors. In the US, the most recognized activist funds are public pension funds and union funds, this latter have been involved mainly in pursuing social goals and started to submit corporate governance issues only recently.

Basically, there are two ways of intervening in corporate matters: shareholder proposals and proxy fights.

The possibility of submitting shareholder proposals was initially recognized by law in 1934, when the Security and Exchange Commission (SEC) issued the Securities and Exchange Act. Under section 14 of this act, Rule 14a-8 permits a shareholder to include a proposal and a 500 – word supporting statement in the annual proxy statement at the expense of the firm. The nature of the proposal is advisory due to provisions in state law, so managers could either react early to the proposal or negotiate with the sponsor in order to reach a compromise.

Typical shareholder proposals under Rule 14a-8 concern voting issues (confidential voting, one share one vote, cumulative voting for directors), antitakeover issues (poison pill rescission[1], anti-greenmail , golden parachute) and Board of Directors issues (majority of outsiders on board or the compensation committee, separation of chairman of the board and CEO, independent members of the board).

Private negotiations can substitute public shareholders' proposals directly inducing managers to change management or strategy. The likelihood and effectiveness of negotiations is however strictly related to the credibility of the threat to present a proposal.

In what follows, I review the key empirical findings about shareholder proposals and direct negotiations, but first I wish to consider the main features of firms that get targeted by institutions, since activism should be evaluated for its impact on corporate performance.

2.1 Selection Criteria for Firm Targeting

Roughly speaking, we can identify two major selection criteria. The first one is based on performance measures, while the other focuses on the probability of success of being active.

Firms that are targets of institutional investors activism are often, but not always, poor by performing. Performance can be measured by stock returns (Opler and Sokobin, 1997, Smith, 1996, Wahal, 1996), or various accounting measures such as the sales growth, the returns on sales, or the market-to-book ratio (Bizjak and Marquette, 1998). Nevertheless, there can be

[1] Or approval if the proposal is filed by a union fund, in fact they are interested in measures that stop hostile takeovers in order to avoid risk of downsizing, so union funds usually cooperate with management to prevent takeovers.

investors that completely ignore performance and choose firms only on the basis of specific issues. For example the presence of poison pills[2] or blank check preferred stock provision can be a cause of targeting.

Institutional investors are also interested in other firm features that are strictly connected with the possibility that activism achieved success. These features are the firm size and the level of institutional investors ownership. Various studies find that targets are relatively large firms[3] and investors are more active where institutional ownership is high[4] and insider ownership is low[5]. The relative importance of insiders is of course a relevant variable, in that these groups are not likely to vote in favour of the proposals presented by institutional shareholders, reducing the possibility of the proposal to pass. The degree of institutional ownership has instead a positive effect on the probability that a proposal pass[6]. In fact, institutions will vote in favour for issues increasing the role of outsiders in monitoring managers.

The positive relation between institutional ownership and firm size can be explained by liquidity motives. Institutions care about the transaction costs caused by the turnover of their portfolios. These costs are larger for illiquid

[2] In the case of poison pill rescission proposals , pill characteristics and firm governance structure affect the frequency of the proposals, see Bizjak and Marquette (1998).
[3] For example firm size measured as book value to assets or market value of equity is significantly high in Smith (1996), Bizjak and Marquette (1998) and Johnson and Shackell (1997).
[4] For example TIAA-CREF (Teachers Insurance and Annuity Association-College Retirement Equities Fund) expressly declares that institutional ownership is a selection criterion.
[5] See Bizjak and Marquette (1998), Carleton et al. (1998), Smith (1996).
[6] An interesting exception to the direct relation between activism and institutional investors ownership level is found by Johnson and Shackell (1997). They report that institutional ownership is relatively low for firms that attract compensation-related proposals. This finding can be explained by the fact that this kind of proposals are usually submitted by individual blockholders rather than institutions.

stocks, that are typically those of small firms. They will therefore avoid large investments[7] in small firms.

2.2 The effectiveness of activism in the US

The great part of the evidence produced until now has been focused on the effects of the submission of proxy proposals at firms. These effects have been evaluated both through performance measures and through discrete changes in corporate governance. Yet, the results of these studies have provided contradictory evidence that make hard to recognize a significant role for institutional investors activism in corporate governance.

The effects of shareholder proposals have been measured by looking at the reactions of different variables following the submission of the proposal. These are stock prices or balance sheet figures such as capital expenditures, growth in sales, or governance features such as CEO turnover, CEO compensation, poison pill rescission, etc.

Among others, Smith (1996) examines activism sponsored by CalPERS[8] from 1987 to 1993 and considers both short and long term market reactions to shareholder proposals[9]. Two days after the initial public announcement of targeting by CalPERS, he finds no significant effects on stock prices. When he considers stock returns reactions in the period that goes from the initial public announcement to the public announcement of the outcome of targeting, he finds that the rise in stock prices is well beyond the total costs created by activism, thus increasing wealth at CalPERS. The author

---

[7] For a detailed analysis about institutional investors' preferences for stock and their effects on asset pricing see Gompers and Metrick (1998).

[8] California Public Employee Retirement System, the largest active pension fund in the US.

[9] In these kind of studies, it is important to establish the date that represents the announcement from which we expect reactions, since it will affect the time at which investors will be informed. Different studies consider alternatively the initial press announcement, Wahal (1996), Smith (1996), the proxy mailing date, or the shareholder meeting date, Del Guercio and Hawkins (1998).

concludes that "overall, the evidence indicates that shareholder activism is largely successful in changing governance structure and, when successful, results in a statistically significant increase in shareholder wealth".

Also Opler and Sokobin (1998) have a positive assessment of shareholder activism. They focus on the Council of Institutional Investors' target list of firms from 1991 to 1994. The Council is an organization of public and corporate pension funds which encourages member funds to take an active role in the protection of pension plan participants' interests. Each fall the Council files a list of under performing firms which should be used by members in their corporate governance activity. The authors show positive two-year stock returns after listing compared to control firms matched by size, book-to-market ratio and prior stock returns, finding positive effects on performance generated by institutional investors activism. Furthermore, they find evidence that operating performance increases after firms are placed on a Council focus list.

A more extensive study by Wahal (1996), considering nine activist pension funds[10] over the period 1987-1993, reaches negative conclusions about the effects of activism both in the short and in the long term. On the announcement day, target abnormal returns are not reliably different from zero. Moreover, the long term abnormal stock price performance of targeted firms is negative prior to targeting and still negative after targeting. Del Guercio and Hawkins (1998), who also investigate activism of five public pension funds in the period from 1987 to 1993, find no evidence from stock price reactions in the three years following targeting as well as in the short term (two days after the shareholder meeting date). The authors, however,

[10] These are: CalPERS, California State Teachers Retirement System, the Colorado Public Employee Retirement System, the New York City Pension System, the Pennsylvania Public School Employee Retirement System, the State of Wisconsin Investment Board, the College Retirement Equities Fund, the Florida State Board of Administration, an the New York State Common Retirement System.

argue that proposals are complements to other control or monitoring devices, so if a firm get targeted by CalPERS or receive a proposal on antitakeover issues, is more likely to receive a hostile takeover bid than its matching comparison firm.

Other studies have tried to find a role for activism focusing on specific proposals. Bizjak and Marquette (1998) for example, look at 193 poison pill related proposals presented at 115 companies between 1986 and 1993 in order to find some evidence that shareholder monitoring is effective. They report that managers are more likely to change the pill following a proposal, and that shareholders are more inclined to submit a proposal to rescind the pill when the firm is performing poorly, presents a high level of institutional holdings and the ownership of executives and directors is low[11].

Finally, a more recent work by YiLin Wu (2000) studies CalPERS activism analyzing changes in US firms board characteristics. Using directors data in companies belonging to the S&P 500, in the period from 1998 to 1995, she finds a significant decline in the median board size. The author's interpretation of this drop is totally attributed to activism by CalPERS, even if this pension fund does not explicitly advice to reduce board size but recommends board independence. This is an example of institutional investor activism that only apparently reaches the objective (increasing the percentage of outside directors), but in practice defies the purpose. In fact, in order to increase the part of outside directors, companies prefer to reduce the size of the board instead of bringing new people from outside, leaving the allocation of the power within the board substantially unchanged.

---

[11] The authors find great support for individual sponsored proposals with respect to pension fund sponsored proposals. This result conflicts with previous findings, see for example Gordon and Pound (1993).

So far we have analyzed evidence based on proposals that go to vote, but a shareholder initiated proposal can actually generate three possible outcomes: the proposal can be omitted, can be withdrawn by the sponsor, or finally, can be included in the proxy material and go to vote. A different investigation approach is based on withdrawn proposals, and emphasizes the role of negotiations stimulated by the proposals. Previous contacts between firm and investor can induce managers to adopt a proposed strategy leading to the withdrawal of the proposal.

Chidambaran and Woidtke (1999) explain that previous studies that find little or no evidence for shareholder activism are biased in favor of finding no effects. In fact, proposals that go to vote are more likely to receive weak support from shareholders since these proposals can be interpreted as a failure in negotiations. On the contrary, withdrawn proposals are those representing a success in prior negotiations. The authors take into consideration the effects produced by the 1992 SEC proxy reforms[12]. Using data from 1989 to 1991 (Pre92 period) and from 1993 to 1995 (Post92 period) they focus on firm performance which is measured by changes in Tobin's Q around the proposal year before and after a proposal is withdrawn. The authors report that corporate governance proposals sponsored by institutional investors and coordinated groups[13] have a higher probability of withdrawal than those sponsored by individuals. This is taken as an indication of the greater negotiating power of large shareholders. Besides, the valuation effects of withdrawn proposals are differentiated with respect to the sub period considered. Prior to 1992 proxy reforms the effects on Tobin's Q are positive,

[12] The reforms were aimed at easing communications among shareholders and releasing proxy information access. Moreover, the SEC increased the range of corporate governance issues allowed to be voted. On the effects of the 1992 SEC reforms see Choi (1997).

[13] Sponsors are classified into three groups: institutions and coordinated groups that are mainly concerned with internal governance proposals (Public pension funds, coordinated platform groups and unions), institutions such as private and coordinated non platform groups that primarily file external control proposals and finally individuals.

whilst there is a negative valuation effect for proposals withdrawn after 1992. CW interpret this evidence as an outcome of the 1992 SEC proxy reforms. They believe that from 1992 onwards there has been a change in the balance of bargaining power between institutions and managers in favour of the former. This shift has forced managers into accepting non value maximizing proposals that are reflected in negative valuation effects on Tobin's Q . These results are also consistent with that of Romano (2001). She stresses the role of the existing subsidization mechanism of the cost of shareholder proposal under the SEC's proxy proposal rules. In the US market this subsidy cannot be justified since institutional investors hold large stakes that do not need subsidization to overcome free rider problems. In her view, institutions should bear the full cost of a losing proposal or a substantial part of the cost in order to improve fund managers' incentives to engage in a deeper and continuing evaluation of their activism.

2.3 Evidence from the UK

The UK represents the most similar country to the US and, at the same time, it deeply differs from the other European partners. It is indeed characterized by widely dispersed ownership and highly developed institutional investors. Occupational pension funds are the largest category of shareholder with a percentage of share ownership of about 20% of the total in 1999. Yet, the scant available evidence about institutional investors activism points to a more passive role of pension funds than in the US.

In the UK there has been, in recent years, a considerable activity towards an activist stance on corporate governance issues by institutional investors[14], but the preferred adopted behaviour remains passivity.

For example, Faccio and Lasfer (2000) analyze the monitoring role of occupational pension funds in the UK. The rationale of the examination is always to find out whether investments, instead of proposals, by pension funds improve performance of firms or induce changes in corporate governance. The emphasis on the investment strategies is induced by the lack of data on shareholder proposals. The authors pose three hypotheses from which to infer an active role for pension funds. They look at three possible outcomes of pension fund activism, i.e., induced decrease in the board size, adoption of the Code of Best Practice which provides for a separation between the role of the chairman and the CEO, and increase in the value of targeted firms with respect to others. The overall result of pension funds investment is very weak. There is neither evidence that investment funds tend to reduce the size of their board or push firms to adopt the Code of Best Practice nor that they increase value of targeted firms.

Moreover, pension funds do not even vote with their feet in that they do not reduce their stakes when performance is poor. All in all, the UK institutional investors do not contribute to enhance corporate governance as they could give their relevance as shareholders.

The recent issue of the Myners' Report (a Treasury commissioned review of institutional investment in the UK) has shed light on some governance failures of UK institutional investors, particularly pension funds and life insurance companies. The report points out the lack of investment expertise among trustees and the role that current regulation has on this

[14] For example, the 1992 Cadbury Report, the 1995 Greenbury Report, the 1995/1996 first Myners Report, and the 1998 Hampel Report, all placed responsibility for reform on shareholders.

aspect. Trustees have no legal incentive, nor any duty to become expert in investment matters. Moreover, this inability has been considered as a natural and inevitable result of the requirement introduced by the Pension Act of 1995, which provides that one third of the trustees should be member nominated. The Report does not accept this interpretation, considering the lack of investment expertise absolutely unacceptable and advising independent professional trustees.

Further, investors show a preference for passivity and are reluctant to intervene with companies in which they invest. Fund managers should instead be more concerned about improvement in corporate performance through activism since this would lead improvements in investment performance and add value for beneficiaries. The Myners' Report concludes recommending the adoption of the US Department of Labor 1994 interpretative Bulletin, which clearly states that activism is an asset to be used on behalf of beneficiaries when it might add value to the investments, particularly "the fiduciary obligations of prudence and loyalty to plan participants and beneficiaries require the responsible fiduciary to vote proxies on issues that may affect the value of the plan's investment". Finally, it recommends that activism should follow an explicit strategy in which are clear the circumstances in which the investors will intervene in a company; the approach they will use in doing so; and how they measure the effectiveness of this strategy.

A very important aspect outlined in the review is connected to the increasing relevance that non executive directors have today in corporate governance. They should be appointed by shareholders and should be sufficiently independent in order to hold executive directors fully accountable. In the current situation executive directors have a lot of power and most of the times they directly nominate the non-executive directors from their peers in other companies who are not fully independent. Therefore, fund managers should care about the appointing method of non-executive directors in order to guarantee an appropriate level of independence.

3. Evidence from Israel and Japan

Mutual funds, insurance companies and pension funds are well developed in some countries that are more similar to Italy from a corporate governance point of view. The countries considered here are Japan and Israel.

The role of institutional investors in Japan is strictly connected to the peculiar ownership structure of firms. Traditionally, large Japanese firms have been controlled by stable cross-shareholdings within important industrial groups known as *keiretsu*. After the second world war, individuals were the major shareholders, and the corporate equity market was characterized by speculators that purchased stocks which management bought back at a higher price (greenmail). In order to protect themselves, Japanese companies increased cross-shareholdings, the shares held by individuals steadily declined while domestic corporations and financial institutions increased their stakes. Non – financial companies represent today about the 2.4% of the total number of shareholders and hold about the 24% of the equity market[15]. The resulting concentration of ownership gives significant power to key shareholders, which are member of *keiretsu*. These have many occasions to communicate with management in informal ways. Moreover, they are usually interested in establishing strong business relationships with the company and may disregard the achievement of performance goals that are more closely related to pure investment purposes. In this way, small shareholders would not necessarily be satisfied. They could in principle indirectly affect management by selling off their shares thus creating a hostile take over threat.

[15] Tokyo Stock Exchange, 1999 Shareownership Survey.

In practice, this mechanism does not work in Japan mainly because of the stable cross-shareholding structure which is sufficient to provide protection against take over.

Recently, the relevance of business corporations' shareholdings has slightly diminished[16]. In 1999, financial institutions were the largest shareholders holding about 36% of stock market value. Among these, a particular role is played by life insurance companies. Even if these companies were the main institutional investors, they have never adopted an active role to protect the interests of beneficiaries acting instead as inside stakeholders.

Yet, the weight of domestic life insurance companies is gradually decreasing, while foreign institutional investors are rapidly increasing their stakes in Japan[17]. Foreign shareholdings in 1999 grew from 3.9% in 1989 to 12.4% of the equity market. This shift in ownership structure is reflected in the shareholders' behaviour. There is now a stronger interest in monitoring management in order to reach higher returns on shares and shareholders, especially foreign shareholders started to directly influence management through voice. For example, CalPERS clearly identified three principles that Japanese corporations should adopt to become attractive to investors. These are: corporate boards that include directors should be independent from the corporation and its affiliates, board size should be reduced and auditors should be independent.

Moreover, several legal changes have made shareholder rights more effective. An important change regards minority shareholder rights. One of the most important rights is that for shareholder litigation against management. Shareholders can claim an inspector to be appointed by the

---

[16] The dilution of cross-shareholdings has been mainly caused by the deterioration in share prices and profits of Japanese firms following the bursting of the financial bubble towards the end of the eighties.

[17] For example CalPERS held $4 billion in Japanese stocks in 1998, and it has recently issued guidelines for corporate governance.

court to check the procedures during a shareholder meeting. The exercise of this right was however subject to a significant petition fee that limited the numbers of lawsuits filed. After the amendment of the Commercial Code in 1993, which reduced significantly the fee, the number of actions against management misconduct increased. Other measures, such as the introduction of incentive schemes for managerial compensation, have helped to improve management responsibility.

Israel presents other features that help understanding the potential for activism by large shareholders. Institutional investors such as provident[18], mutual and pension funds are the most important holders of publicly traded shares not held by insiders, but they find some difficulties to effectively monitor firm managers. Israeli banking system is very similar to that of Continental European countries, but banks play an even more important role in the market. The banking system is truly universal in the sense that banks manage investment funds, control subsidiaries that specialize in underwriting and also own the stocks of manufacturing and insurance firms even up to 25 percent of a single firm's equity. Provident funds and mutual funds are mostly bank managed with the three largest banks owning about 75 per cent of them. These funds show a very poor performance that can be partially explained by the asset allocation policy which is biased in favour of illiquid deposits and government bonds. In turn, pension funds and life insurance companies mostly invest in subsidized government bonds enjoying significant tax benefit. Poor asset allocation policy can be explained by a number of factors. Funds could trade excessively to generate fees for their brokerage affiliates; in

[18] Provident funds are long term saving instruments, operating as defined contribution schemes, enjoining tax benefits and differ from pension funds because they can be redeemed just at one point in time, minimum after 15 years, whilst pension funds create monthly payments.

addition, affiliation pressures could force investments that are not in the best interests of beneficiaries.

The empirical available evidence shows that there is conflict of interest in universal banking. The Initial Public Offering (IPO) wave observed in Israel from 1990 through 1996 has been very impressive, more than 160 manufacturing and software corporations and 300 other firms issued stock through IPOs, and the Israeli equity market has had one of the fastest growth in the world over the last decade. Most of these shares were purchased by banks through their controlled provident and mutual funds. Ber, Yafeh and Yosha (2001), using data on Israeli firms in the 1990s, find that there is conflict of interest in the combination of bank lending, underwriting and fund management. In such a situation, banks must choose between selling the IPO stocks of a client firm at a high price providing a great amount of cash in exchange for minimal dilution of ownership, or selling these stocks at a low price, generating good returns for investors in the bank managed funds. The evidence from BYY shows that banks favor client firms rather than fund investors. This situation can be partially explained by the lack of independence of fund managers that makes them buy overpriced securities[19].

In conclusion, it seems that Israeli institutional investors neither monitor management nor pursue passive asset allocation, completely disregarding beneficiaries' interests.

---

[19] As BYY remind in their paper, the existence of conflict of interest can be exemplified by the following, even if exceptional story: in 1995 the Israeli Treasury filed a compliant with the police against the two largest Israeli banks that had bought in 1994 , through their provident funds, a large fraction of the IPO of an Israeli company that was clearly in bad shape. The reason for purchasing the stocks was that the company owed large sums to the banks who bought the firm's stock, on behalf of the depositors in the provident funds, to prevent the company from going under. In the two months following the IPO, the company lost about $7 million, the entire amount raised in IPO. The story was published in Telegraph (June 27, 1995).

4. Investors activism in Italy

The available empirical evidence concerning institutional investors' activism in Italy is mainly anecdotal. For instance, an example of institutional investors' activism in the Italian financial market is linked to the acquisition of Telecom Italia Mobile by Olivetti. The stock conversion ratio was initially fixed at a level that was considered too low by both the Olivetti independent advisor and the minority shareholders' advisor, so that the compensation previously announced resulted as inconsistent and complaints by large investors led to the abandonment of the plan.

There is however some new evidence concerning activism by Italian institutional investors. In particular, a study of mutual funds by Bianchi and Enriques (1999), helps understanding the problems that may prevent pension funds from being active in the future. They focus on several features of Italian mutual funds that are likely to influence activism, namely: the size of their shareholdings, their investment strategies, the ownership structure of both the institutions and listed companies, the legal rules on corporate governance. Considering the number of shareholdings larger than 1%, they observe that among 221 holdings, about 60% is concentrated in the hands of five Italian fund managers with an average of 25 relevant holdings each. They consider these five funds as good candidates for activism. This priori is reinforced by the fact that fund managers show highly concentrated portfolios in a low number of securities.

In contrast to the aforesaid positive findings, there are aspects concerning ownership structure of both institutional investors and listed companies that weaken the potential for an impact of pension funds on corporate governance. Of the 221 relevant shareholdings only 4 belong to "independent" mutual fund managers, the rest being affiliated to bank or insurance groups. Moreover, the ownership structure of firms is still highly concentrated: at the end of 1998 there were 35 out of a total of 218 listed companies that could be defined public companies. The consequences of highly concentrated ownership for pension fund effectiveness are negative and the reasons are fairly intuitive: if control is unstable the threat to exercise the exit option is more dangerous as it increases the possibility of a hostile takeover. By the same token, the threat of submitting a shareholder proposal will be less effective when the controlling shareholders are a stable group (as already discussed for the Japanese case).

5. Board Representation and Conflict of Interest

The evidence about pension funds activism has shed light on the relevance of the motivations that might push investors to become active. In the US, public pension funds are the most active institutions in challenging managers, large private pension funds are reluctant to be intrusive in the business of their portfolio companies preferring a passive role instead of exerting their power and risk to cause commercial reprisal.

The fact that public pension funds are the most active ones is not however a guarantee for plan participants who are mostly concerned with the achievement of higher risk adjusted returns on investment. Public pension fund trustees are subject, to varying degree, to political pressures. In the US, State and local Government pension funds are governed by Board of Directors that can include elected members that not infrequently are active employees or also retirees. In this scenario, the way in which funds are managed cannot follow economic criteria and under perform privately managed funds.

On this point, the study by Mitchell and Hsin (1994) shows that Board composition is a significant explanatory variable for public pension fund investment returns. They find that following a 10% increase in the retirees representation on the Board, investment returns decrease of about 2%. Moreover, investment performance is negatively affected by investments in specific state projects mainly aimed at pursuing social benefits rather than high returns.

Furthermore, Woidtke (2001) investigates the effects on firm value distinguishing between public and private pension fund ownership. Once again, she finds that the relative firm value, measured by industry adjusted Tobin's Q, is positively associated to private pension fund ownership and negatively related to that of public pension funds. So even if public pension funds are more active than private ones, these latter seem to gain more from their investments. The author take this evidence as consistent with the view that public pension fund managers might be motivated more by political or social influences rather than by firm performance.

In Italy the existing institutional investors did not show any activism aimed at pursuing improvement in investors wealth. Among other limitations, the existing connections between many mutual funds and banking groups amplify the potential of conflict of interest that negatively affects the incentive for institutions to become active. We can expect that the development of pension funds may follow that of mutual funds possibly adding other problems. Indeed, the provision of some kind of board representation, for example by unions or retirees, might put further pressures on pension fund management, so the way in which the governance of pension funds is designed seem to have a lot of relevance.

5.1 Pension funds as third party

One way that pension funds can follow so as to guarantee a certain degree of independence and avoid potential pressures on their fund management is their development as an independent party.

One interesting aspect of the recent developments in the US is the increasing importance of organization that help institutions to serve investors' interest acting both collectively and independently.

The most important American organization is the Council of Institutional Investors. Founded in 1985 in response to controversial takeover activities that threatened the interests of pension plan beneficiaries, it consists today of over 100 pension fund members who together own more than $1 trillion in financial assets and represents a significant voice for institutional shareholder interests. The Council provides a forum for funds to share information and to jointly monitor corporate performance, executive pay and governance related issues. Such an organization could also improve cooperation among institutions that make initiatives more prone to succeed, creating a greater degree of credibility when challenging management, and lowering the costs because of economies of scale in activism.

In Italy the birth of an organized, independent third party monitoring organization for pension funds could enhance the current situation and increase the degree of independence of fund managers.

6. Conclusions

Institutional investors' presence is specific to companies with large market capitalization. The evidence about the effects of institutional investors activism on corporate governance comes mainly from the US and does not provide striking results of effectiveness on corporate performance. The most successful activism seems to come from direct negotiations between management and institutions. Even if there is a lot of participation on corporate governance matters by public pension funds, this is not always aimed at improving performance of targeted firms. In particular, board members seem to be interested in private benefits rather than beneficiaries' interest. On the contrary, institutions effectively vote with their own feet by selling poor performing companies before CEO turnover.

In other countries – including the UK – there is no systematic evidence of institutional activism. There is only some casual evidence of "voting with their feet" by foreign institutions in Italian and Japanese public companies. In Israel existing local institutional investors are not independent enough from banking groups in order to pursue beneficiaries' interests In Japan there are barriers connected with the ownership structure of firms even if there are movements towards the Anglo Saxon model of corporate governance.

Available evidence is scarce, especially outside the U.S. However, some implications can be drawn concerning the future role of pension funds in Italian corporate governance. Pension funds will not directly affect the governance of small companies, in that their investment is directed towards more liquid ones. Moreover, we should not expect improvements in the governance of large firms following the development of local pension funds unless several conditions are satisfied. An important provision is a careful design of board representation in occupational pension funds. Unfortunately this currently mirrors the design of UK ones, which turned out to be poor according to the recently issued Myners' Report. Among the recommendations presented in this Report, an explicit provision of the circumstances in which pension funds become active and what measures will be used to evaluate the effectiveness of the actions would be valuable for Italy too.

The lack of good governance among occupational and private funds, could be partially compensated by competition. Beneficiaries could indeed choose the best performing fund, if search costs and information asymmetries allow. Competition is however not ensured under current regulation because the fiscal benefit for employees is associated to investment in occupational pension funds only. This benefit should therefore be extended to private funds.

The private funds industry is however characterized by several group-affiliated institutional investors whose investment policy is likely to be plagued by conflict of interest similar to those existing in Japan and Israel. Supervision by market authorities and performance-related managerial compensation can help mitigating this problem.

References

Ber, H., Y., Yafeh and O., Yosha (2001), Conflict of Interest in Universal Banking: Bank Lending, Stock Underwriting, and Fund Management, *Journal of Monetary Economics*, February 2001.

Bhide, A. (1993), The Hidden Cost of Stock Market Liquidity, *Journal of Financial Economics* 34, 31-51.

Bianchi, M. and L., Enriques (2001), Corporate Governance in Italy after the 1998 Reform: What Role for Institutional Investors?, *Quaderni di Finanza* CONSOB, No. 43.

Bizjak, John M., Christopher J., Marquette (1998), Shareholder Proposals to Rescind Poison Pills: All Bark and No Bite, *Journal of Financial and Quantitative Analysis* Vol. 33, No. 4.

Black, B. (1998), Shareholder Activism and Corporate Governance in the United States, *The New Palgrave Dictionary of Economics and the Law*.

Blass, A., Yafeh, Y. and O., Yosha (1997), Corporate Governance in an Emerging Market: The Case of Israel, *Bank of Israel* Discussion Paper No. 97/08.

Choi, S. (1997), Proxy Issue Contests: The Impact of the 1992 Proxy Reforms, *University of Chicago Law School* working paper.

Del Guercio, D., and Jennifer, Hawkins (1998), The Motivation and Impact of Pension Fund Activism. *University of Oregon* working paper.

Faccio, M. and Ameziane M., Lasfer (2000), Institutional Shareholders and Corporate Governance: The Case of UK Pension Funds, *CeRP* working paper No. 11/01.

Gibson, M. (1998), Big Bang Deregulation and Japanese Corporate Governance: A survey of the issues, *Federal Reserve System*, International Finance Discussion Paper No. 624.

Gillan, Stuart L., and Laura T., Starks (1998), A Survey of Shareholder Activism: Motivation and Empirical Evidence, *Contemporary Finance Digest*, Autumn 2, 3.

Gompers, P., and A., Metrick (1998), Institutional Investors and Equity Prices, *NBER* working paper No. 6723.

Gordon, L., and J., Pound (1993), Information, Ownership Structure, and Shareholder Voting: Evidence from Shareholder-Sponsored Corporate Governance Proposals, *Journal of Finance*, 48, 697-718.

Johnson, M., and M., Shackell (1997), Shareholder Proposals on Executive Compensation, *University of Michigan* working paper.

Karpoff, J. (1998), The Impact of Shareholder Activism on Target Companies: A Survey of Empirical Findings, *University of Washington* working paper.

Maug, E. (1997), Large Shareholders as Monitors: Is There a Trade-off between Liquidity and Control?, *Journal of Finance*, Vol. 53:1, 65 – 98.

Mitchell, O., and Ping Lung, Hsin (1994), Public Pension Governance and Performance, *NBER* working paper No. 4632.

Myners, P. (2001), Institutional Investment in the United Kingdom: A Review, UK Treausury commissioned review of institutional investment.

Monks, R. (1995), Corporate Governance and Pension Plans, in Zvi Bodie and E. Philip Davis eds., *The Foundations of Pension Finance*, Vol I, Ch. 15, An Elgar Reference Collection, Cheltenham, UK – Northampton, MA, USA.

Opler, T., and Jonathan, Sokobin (1997), Does Coordinated Institutional Activism Work? An Analysis of the Activities of the Council of Institutional Investors, *Ohio State University* working paper.

Parrino, R., Sias, R. and L., Starks (2000), Voting with their Feet: Institutional Investors and CEO Turnover, mimeo.

Romano, R. (2001), Less is More: Making Shareholder Activism a Valuable Mechanism of Corporate Governance, *CeRP* working paper No. 12/01.

Smith, Michael, P. (1996), Shareholder Activism by Institutional Investors: Evidence from CalPERS. *Journal of Finance*, 51:227-252.

Tokyo Stock Exchange (2000), 1999 Shareownership Survey.

Wahal, S. (1996), Pension Fund Activism and Firm Performance, *Journal of Financial and Quantitative Analysis*, Vol. 31, issue 1.

Woidtke, T. (2001), Agents Watching Agents? Evidence from Pension Fund Ownership and Firm Value, *Texas A&M University* working paper.

Wu, YiLin (2000), Honey, CalPERS Shrunk the Board!, mimeo.

Yasui, F. (1999), Corporate Governance in Japan, mimeo.

Our papers can be downloaded at:

http://cerp.unito.it

CeRP Working Paper Series:

N° 1/00	Guido Menzio	Opting Out of Social Security over the Life Cycle
N° 2/00	Pier Marco Ferraresi Elsa Fornero	Social Security Transition in Italy: Costs, Distorsions and (some) Possible Correction
N° 3/00	Emanuele Baldacci Luca Inglese	Le caratteristiche socio economiche dei pensionati in Italia. Analisi della distribuzione dei redditi da pensione (only available in the Italian version)
N° 4/01	Peter Diamond	Towards an Optimal Social Security Design
N° 5/01	Vincenzo Andrietti	Occupational Pensions and Interfirm Job Mobility in the European Union. Evidence from the ECHP Survey
N° 6/01	Flavia Coda Moscarola	The Effects of Immigration Inflows on the Sustainability of the Italian Welfare State
N° 7/01	Margherita Borella	The Error Structure of Earnings: an Analysis on Italian Longitudinal Data
N° 8/01	Margherita Borella	Social Security Systems and the Distribution of Income: an Application to the Italian Case
N° 9/01	Hans Blommestein	Ageing, Pension Reform, and Financial Market Implications in the OECD Area
N° 10/01	Vincenzo Andrietti and Vincent Hildebrand	Pension Portability and Labour Mobility in the United States. New Evidence from the SIPP Data
N° 11/01	Mara Faccio and Ameziane Lasfer	Institutional Shareholders and Corporate Governance: The Case of UK Pension Funds
N° 12/01	Roberta Romano	Less is More: Making Shareholder Activism a Valuable Mechanism of Corporate Governance
N° 13/01	Michela Scatigna	Institutional Investors, Corporate Governance and Pension Funds