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Awakening giants? The politically contested modification of institutional investors

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Abstract

Purpose – *The purpose of this paper is to offer a political perspective on modifications in corporate governance regulation. In the wake of the financial crisis, the investment rationale of institutional investors is being pushed away from a focus on financial market liquidity and short-term trading. From a political perspective, this modification entails consideration both of investment horizon and of the definition of corporate value.*

Design/methodology/approach – *The paper narrates the historical policy debate on institutional investors as corporate governors. Building on this point, a conceptual framework is developed to further the understanding of the current shifts in policy debate of institutional investors as governors.*

Findings – *The authors find a strong policy impetus to move away from certain liberal market assumptions of efficient financial markets and the positive effects of privatization, toward viewing markets as institutionally embedded. Based on their knowledge of corporate governance regimes' political economy, the authors argue that this shift brings intensified engagement of institutional investors in corporate affairs. The reasons for why and how this might be politically contested are specified. In conclusion, propositions regarding the outcome of such contestation in different national corporate governance regimes are offered.*

Originality/value – *Pointing to the predominantly European stakeholder value versus shareholder value discussion, the authors claim that the corporate governance policy debate related to intensified engagement of institutional investors in corporate affairs is still in its infancy. Their political perspective, including propositions for further elaboration, offers a contribution to further academic debate.*

Keywords *Regulation, Corporate governance, Institutional investors, Stakeholder value*

Paper type *Conceptual paper*

1. Introduction: the politics of institutional investment

In most Western capital markets, domestic as well as foreign institutional investors own 50-60 per cent of the capital in listed companies (Çelik and Isaksson, 2013). This category of investors includes pension funds, investment funds such as retail funds and government-sponsored pension plans now representing a significant force in domestic capital markets and as corporate governors. In the academic debate, these investors generally have been treated as a group of uniformed, passive investors with a propensity to use the "exit" option when discontent, rather than the options of loyalty and voice (Thomsen, 2004; c.f. Hirschman, 1972, on these generic action strategies available to minority stakeholders in large organizations). We contend that this is a rather simplified image, as the rationale of institutional investors is shaped by, and part of, particular national corporate governance regimes. As intermediaries, their operations have been complexly regulated everywhere, and these regulations have been politically contested all over as well. In recent decades, regulators have tended to prohibit active engagement in corporate decision-making[1]. This resulted in an outcome of institutional investors taking the role of predominantly passive minority shareholders in corporations all over the world.

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Following the 2008 financial crisis, there appears to be a shift in academic and political discourse with regard to the role of the institutional investors in the governance of listed companies. Many calls for "engaged" governance in the part of institutional investors are made[2]. What has come into question is the foundational notions of efficient capital markets and portfolio optimization models (Markowitz, 1952; Modigliani and Miller, 1958; Fama, 1970), emblemized by awarding the 2013 "Nobel prize" in Economics to Robert Schiller, figurehead of the behavioural finance movement and Eugene Fama, orthodox financial economist.

On the basis of the political science and sociological theory, we argue that the rationales of institutional investors are best understood as institutionally embedded, shaped by and shaping economic, legal and cultural factors. As a result, the likelihood of a reconfiguration of the institutional investor organizations from a passive minority shareholder rationale toward active or "engaged" stakeholder rationale will be interconnected with the future development of national corporate governance regimes. Based on the conceptual frameworks of Aguilera and Jackson (2003) and Gourevitch and Shinn (2005), we point to the centrality of the formation of alliances between involved constituents (i.e. institutional investors, corporate management, labour and minority shareholders). In all probability, any modification of institutional investor operations would entice domestically powerful interest groups to contest such changes. We therefore suggest that what we term the political "independence" and "clout" of institutional investors will be a decisive explanatory factor in any overall modification.

By developing Roe's (2003) influential theory of static political preferences explaining corporate governance regimes in different parts of the world, political scientists Gourevitch and Shinn (2005) direct our attention to the formation of (political) preferences as an explanatory "variable" in comparative corporate governance. Focusing here on the changing rationale of institutional investors as corporate governors in the post-financial crisis era, we add the discipline of economics to the conversation – particularly, financial economics and its current importance to the formation of political preferences – that is of central importance to comparative corporate governance research. We argue that corporate "performance", along with the notions of "efficiency" or "optimality", is a value-laden concept with a "moral dimension" (Etzioni, 1961; Young and Thyil, 2008). We thus turn attention to the continuing divide in corporate governance research between the "stakeholder" and "shareholder" visions of the firm (Donaldson, 2012).

In a similar vein, Australian economist Quiggin (2010) dissects five interrelated "zombie" ideas in economics: the supposed Great Moderation of the macroeconomy, dynamic stochastic general equilibrium modelling, trickle-down economics, (the universal benefits of) privatization and the efficient market hypothesis[3]. The term "zombie" that Quiggin uses refers to the sociologically familiar phenomenon that some theoretical ideas remain alive and well and are used as practical guides to political and regulatory action, even though they have been shown to be outright wrong, incomplete or ontologically misleading ("reified") (Callon *et al.*, 1998; Fligstein, 2001).

In this article, we highlight how institutional investors have been the primary carriers on a global scale of at least two of these "undead" ideas for quite some time now. Across the globe, these organizations have been significantly shaped by ideas of the value of privatization and the truth value of the efficient market hypothesis. Hence, financial capital has been primarily allocated to private rather than public investment and in a manner in which the ultimate beneficiary (all citizens) has exercised weak influence upon the investment, leaving institutional investors the mandate, as intermediaries, to freely acquire and sell securities with the only purpose of making a financial profit (Coffee, 1991).

The rest of the text proceeds as follows: in Section 2, we present the theoretical building blocks for a political understanding of the institutional investment modifications in the wake of the crisis. In Section 3, we discuss the dominant operational rationality of the institutional

investor that, up until now, has been based on portfolio allocation models of investment. We analyse in Section 4 the variety of critiques of institutional investor practices within the legal and regulatory realm, including that of an investment style skewed towards financial market liquidity and short-termism. Section 5 presents a summarizing and descriptive conceptualization of transforming corporate governance regimes. This section also includes a number of propositions for how the political contestation of institutional investment may appear in different national contexts. We conclude the final section of our paper with some points of discussion.

2. Framework for a political analysis of institutional investment

Different corporate governance systems are theorised in academic discourse as being embedded in a historical context related not only to law but also to culture and traditions; as such, they can be understood through, for example, Granovetter's (1985) theory of social embeddedness of economic institutions and action. In political science and sociology, a political approach to organizations and institutions generally encompasses which "preferences plus institutions equals policy outcomes that shape corporate governance patterns" (Gourevitch and Shinn, 2005, p. 278).

With this view, actors and their goals are not to be seen as a given; they tend to be mediated through clear agency contracts and are complexly constructed by the positions upheld by actor categories in the society (Aguilera and Jackson, 2003; Gilson, 2006). Neither "principals" – such as shareholders, who come in different forms and with different investment horizons and values – nor "agents", such as directors and executive managers with different capabilities and agendas, are thought to behave as textbook rational actors. Rather, they make bounded rational decisions based on available information and on their culturally specific social position (Simon, 1957). One important question is then *how* a particular actor category – such as institutional investors – interprets and enacts its responsibilities as fiduciaries for policyholders and ultimate beneficiaries.

Hawley and Williams (2000, 2007) use a normative shareholder value view of corporate purpose with relation to this. They have amply described the emergence of *fiduciary capitalism*, implying that most citizens – through participation in institutional investment – have become indirect holders of investments in almost all listed companies (i.e. "universal owners") and dependent on the welfare of a broader economy for their future savings or pensions. According to Hawley and Williams, such investors *should* take into consideration that a seemingly shareholder value-driven downsizing in one company might have negative effects on other companies in the investment portfolio: such as sub-contractors, etc.

This echoes, for example, the views of Shleifer and Summers (1988), who questioned the then received view among financial economists that share price increases of firms involved in takeovers measure efficiency gains from acquisitions. Even if such gains exist, most of the increase in the combined value of the target and the acquirer is likely to come from stakeholder wealth losses, such as declines in the value of sub-contractors' firm-specific capital or employees' human capital. Shareholder gains may be redistributions from other stakeholders. This potentially entails long-run deterioration in the functioning of the corporation. In financial economics, it is perhaps more common to point out that empire-building overinvestment in a particular sector of the economy is not in the rational interest of a universal shareholder; however, it may be so on the part of the managerial empire builder and her allies, if she succeeds in surviving the overcapacity crisis restructuring that inevitably follows such an overinvestment.

The typical universal shareholder, *if rational*, often has an economic interest that differs (and *should* differ) from a particular shareholder and/or manager and/or labourer. Any such effective role as "universal shareholder" presupposes the use of the shareholders' rights to

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influence corporate decision-making. Such an influence may, in theory, flow from both timely entry/exit and voice.

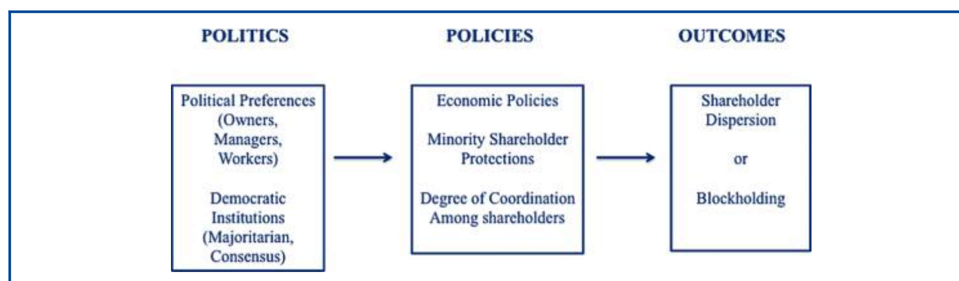
Here, we pay special attention to the standard analytical schema of politically contested corporate governance, as used by Aguilera and Jackson (2003) and Gourevitch and Shinn (2005). As Figure 1 illustrates, three actor categories dominate the politics of corporate governance and the choice between the degree of coordination and the level of minority shareholder protection: investors, managers and labour. These categories, working through political institutions, establish the policies of direct impact on the economic conditions for institutional investors of corporate governors. Only in particular settings, with *de facto* minority protection and developed capital markets, does a situation of dispersed shareholdings make economic sense.

Institutional investors are regarded as agents in this framework, and the question may be posed: For whom: owners, managers or labourers or, rather, which combination of investor/owner, manager and/or labour interests are realised through institutional investor operations? In their global survey, Gourevitch and Shinn show that institutional investors have allied with management, other minority shareholders or controlling shareholders to have an impact on corporate governance, primarily toward "transparency". However, they do not necessarily differentiate between different kinds of institutional investors, and they do not problematize the long-term macroeconomic or other consequences of different corporate governance regimes. Gourevitch and Shinn explicitly abstain from normative statements in comparative corporate governance.

We especially emphasize here that the role taken by, or given to, institutional investors in corporate governance is connected not only to the interpretation of their mandate but also to the "contingencies" of the corporate governance regime in general. In most jurisdictions, the directors on corporate boards have a legal responsibility to multiple stakeholders: including bondholders, in the case of financial distress. The promotion of (current) shareholder value (which means short term) is not explicitly mandated anywhere; yet it is overwhelmingly promoted in corporate law. However, in social democratic or corporatist nations in continental Europe and in Scandinavia, a formal or informal bargain regarding the very purpose of the corporation has been historically struck. Under the influence of a combination of managerial and labour interests, large industrials in particular have been treated as national institutions, rather than as private property. Much has been written with regard to this as being not only legitimate but also historically conducive to economic value creation (Aglietta and Rebérioux, 2005; Berle and Means, 1932).

In corporate governance research, the "epistemic fault line" between these two *normative* views of corporate purpose is overwhelmingly clear (Donaldson, 2012). Corporate purpose either should or should not be determined as shareholder value maximization. If it is not, then alternative notions of corporate value are implied, in terms of value to stakeholders. There are US scholars who even argue that all corporate law ultimately does not hold directors responsible for the financial interest of shareholders, but for the company itself

Figure 1 The political explanatory schema of corporate governance regimes, according to Gourevitch and Shinn (2005)



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(Stout, 2012). Others, however, define the very purpose of corporate governance research as finding out how investors secure maximum financial returns (Shleifer and Vishny, 1997). We argue that the choice is ultimately what most people understand to be "political ideology". Quiggin (2010) and Roe (2003) differentiate between market liberalism and social democracy as the two main competing ideological stances in Western politics.

Following a long-standing tradition not only in political science and sociology but also in economics (Stigler, 1971), we do not understand regulation to be necessarily the result of some benevolent protection of the common good, but rather as the rules demanded by those who have wielded political power. In the same vein, Coffee (1991) also claimed that the US capital market regulatory framework should be understood as the result of political constraints, liquidity preference and minority shareholder exploitation. Coffee argued that dispersed shareholdings in the USA was primarily the result of the US legal development at the turn of the twentieth century, which limited the activities of banks and promoted market activities for raising capital. This, however, had little to do with any particular idea about maximizing the value creation of corporations or maximizing the social value (however defined) of output in the society as a whole. The same can be said about business groups in both Europe and Asia, which are typically explained as political, cultural and economic phenomena (Collin, 1998; Hall and Soskice, 2001; Gourevitch and Shinn, 2005). Consequently, private controlling shareholders, management and governments have, in many ways, defended significant "wedges" between ownership (provision of capital) and control (decision-making) in large industrial corporations; this has often left institutional investors with the only option of being minority shareholders, providing an increasing share of capital, while being barred from direct impact on corporate decision-making. The regulatory and ideological context has effectively barred institutional investors from having political clout, turning these organizations into "zombies" in financial capitalism.

3. Zombies in financial capitalism

In the era of financial capitalism – that is to say, the era following the liberalization of financial markets that began in the 1970s and 1980s – life insurance companies, mutual funds, pension funds, activist funds and hedge funds, as well as state-owned sovereign wealth funds and state-owned pension funds, have all taken an increasingly dominant role on global capital markets. As an investor category, modern institutional investors share some common characters: They invest assets that have emerged from collective or pooled savings. Thus, they act as intermediaries and fiduciaries for distant investors, which may be future retirees, long-term private mutual savers or just citizen investors.

These institutional investors commit capital to long-term investments in the form of bonds and stocks. The scope of both investment strategies is limited by different kinds of regulation. Central to our concerns here is that bondholding implies a legally binding promise of a return on investment, without any additional rights regarding corporate affairs, except in situations of insolvency. Shareholding, on the other hand, along with the right to take part of dividends, implies the *possibility* of using shareholders' rights to influence corporate decision-making. Such influence may, in theory, flow from both timely entry/exit into and out from an equity holding an informal or formal voice (such as voting at general meetings).

In practice, institutional investors across the globe have been either "passive" or "active", which has then implied strictly tracking a particular capital market index or trying to beat it by overweighting and underweighting particular assets (Black, 1998; Hellman, 2005). Being overweighed or underweighted as shareholder in a particular company has little to do with being a "shareholder activist" or a "controlling shareholder". Such shareholders hold small or large (yet always significant) stakes in a particular company and voice their opinions on how the company should be run. A few academic studies of these kinds of corporate governance *processes* have emerged (Becht *et al.*, 2010; Kallifatides *et al.*, 2010).

Rules regarding investment decision-making give institutional investors a particular position among corporate stakeholders (Schneider, 2000; Ambachtsheer, 2005, Johnson and de Graaf, 2009). These rules can be quantitative and can limit investments in various asset classes or the level of engagement in a particular asset, such as shares in a listed company. The rules can also be qualitative, allowing for more flexibility, yet are formulated in terms of concepts such as prudence, care and loyalty. Such rules are the results of political decisions. Most countries feature a mixture.

Since the 1980s, prudent asset management has been predominantly synonymous with diversification and risk allocation in accordance with the principles that follow from the theory that most institutional investors have many different asset classes in their portfolio. When they invest in equities, they have many stocks in their portfolio – often over a hundred different investments (and thousands, if the portfolio is investing globally) – and very small shareholdings in each of them, thus making active voice-based governance work "un-economically" on the part of these investors, limiting them to a role as passive minority shareholders. Another party then handles any corporate decision-making.

In principle, there are two models for how other principals than collectives of dispersed minority shareholders exercise governance of companies: for example, "managing" their assets. This work is either run by hired managers or by actively engaged controlling shareholders, which is often a family, a financial institution or a trust. In the USA and the UK, hired managers dominate corporate decision-making. Throughout the rest of the world, it is the controlling shareholders that dominate corporate decision-making (Shleifer and Vishny, 1997).

The US and UK models for corporate governance are intellectually and practically linked to the prevalence of liquid financial markets and to specific legal traditions in Anglo-American culture (Berle and Means, 1932). The models imply that management is to be induced to seeking the maximization of shareholder value, leaving the capital market to allocate financial capital to real investment via the price mechanism. The Jensen and Meckling (1976) agency theory of the firm defines ways in which a market of disorganized financiers can achieve these aims at the lowest possible agency cost. Executive compensation programmes, board composition to enable efficient monitoring in the interest of the shareholders, competitive product markets and the market for corporate control, which includes the (threat of) hostile takeover, are some of the governance mechanisms available to optimize these contractual rights so as to minimize agency costs (to maximize shareholder value).

A number of academics claim to have found ample evidence that these models are better at producing shareholder value (Rajan and Zingales, 2001; Holmstrom and Kaplan, 2001). On these grounds, academics, politicians and regulators have come to expect a global convergence in corporate governance towards the Anglo-American shareholder value model with companies emerging with a Anglo-American dispersed shareholder structure (Kraakman and Hansmann, 2001). Continental European corporate control models, with blockholders and reinforced by control enhancing mechanisms such as cross-holdings, pyramids, golden shares, etc., giving rise to business groups, not seldom with state involvement, have been expected to lose their attractiveness (Kraakman and Hansmann, 2001). This belief in the shareholder value models shaped the policy of the European Commission, which strongly supported the development of liquid capital markets and a "level playing field" for large corporations in Europe. This included the final adoption of the 13th Directive on Takeovers (2003), geared to stimulate cross-border mergers and acquisitions.

In recent decades, institutional investors have acted in the political sphere, as catalysts for change in corporate governance practises across the globe pushing for a "level playing field" for investment (Tricker, 2009) and encouraging, for example, the EU Commission and European national policymakers to bring forth regulations and recommendations in support

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of liquid capital markets *and* convergence towards the shareholder value rationale form of corporate governance (Horn, 2012). The concerted activities of globally and domestically active institutional investors have been seen in many national capital markets. One example is a successful push for reforms of the French stock market (Cioffi, 2000). In the USA, company-sponsored pension funds have allied themselves with employees to oust management of US listed companies (Gourevitch and Shinn, 2005). Domestic and foreign institutional investors in Sweden fought and partly succeeded in levelling the price difference between shares with different voting rights during takeover offers (Jonnergård and Larsson, 2009).

Institutional investors have been champions in all these contestations of rather short timelines and of the market liberal "shareholder value" notion of corporate purpose. However, we venture to claim that the above-described market liberal package of ideas, and the role ascribed to institutional investors in the economies (as minority shareholders pushing shareholder value maximization and/or vague notions of "transparency"), has met with increasingly powerful criticism in the wake of the 2008 financial crisis. This criticism has primarily been directed towards perceived "short-termism" in specific company matters. We now divert our attention to that criticism.

4. Awakening: irrational markets and short-termism

Description and prescription regarding the role of institutional investment has been and remains disputed in both the policy circles and the academy. Amplitudes in that debate have certainly increased. There has been a wave of claims that "short-termism" is the aggregate result of portfolio allocation models, with the consequence that shareholder and managerial actions are directed to financial profit for *incumbent* shareholders rather than long-term value creation. Does good corporate governance, which is considered a collective good, really emerge in a market where most investors are passive index trackers, that is, free riders upon the supposed efforts of others (Grossman and Hart, 1988)?

Another stream of questioning concerns the practicalities of fruitfully reforming corporate governance regimes around the globe. Academics on both sides of the Atlantic have underscored the complexities of successfully transforming governance regimes by piecemeal altercations in regulations and paths of action. The import of particular regulations tends to be heavily resisted and gives rise to unexpected and problematic effects (Coffee, 1991; Romano, 2004; Fligstein and Choo, 2005; Aguilera *et al.*, 2008, García-Castro *et al.*, 2013).

Among the unexpected consequences are those that stem from the stimulation of a "market for corporate control" in Europe, which is in line with the dominating US governance regime. That, which emerges in an environment of controlling shareholders, index-tracking institutional investors and differently regulated corporate decision-making, is not a "level playing" field or an "efficient" allocation of corporate control. At worst, there is an order of things in which companies less protected by regulations are taken over by the more protected ones, with no discernable connection to the quality of corporate governance or of management. Such control transfers primarily benefit hoards of intermediary agents, such as legal council, investment banks and public relations firms (Wymeersch, 2008; Kallifatides *et al.*, 2010).

Here, we argue that more foundational and questionable theoretical notions lie beneath these specific critiques. The shortcoming of many policies is that they rely on the idea of capital markets being rational. In a restricted technical sense, these markets may be considered rather "efficient"; they are certainly not considered to be rational. Empirical evidence clearly shows that a multitude of investors "follow the herd". Institutional investors are particularly prone to track particular indices rather than individual companies. With such a large number of investors in a market not deploying rationality in decision-making – due to ignorance, inability or lack of appropriate incentives – pricing becomes

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highly volatile. This irrational volatility is widely held to inhibit long-term value creation in the particular company (FSA, 2009; Heineman and Davis, 2011).

The US Institute of Chartered Financial Analysts defined short-termism in 2006 as an "excessive focus of some corporate leaders, investors, and analysts upon short-term earnings guidance, coupled with a lack of attention to the strategy, fundamentals, and conventional approaches to long-term value creation" (Krehmeyer *et al.*, 2006, p. 3).

Scholars Jackson and Petraki (2011) refer to short-termism as a social process caused by a self-reinforcing shortening of time horizons produced by the interaction between hand shareholders – pension funds, private equity, hedge funds – and managers. The short-term behaviour is supported by the activities from gatekeepers: such as securities analysts, credit rating agencies, auditors and the mass media, mediating these relationships (c.f. Coffee, 2006; Kallifatides *et al.*, 2010). As part of this social process, short-term wealth capture through the maximization of stock market price becomes the measurement of success.

There is a range of empirical evidence on short-termism. Surveys among financial executives and managers show that a great majority of them would reject a project based on the fact that in the short term, it may take the quarterly earnings below the consensus expectations or would give up economic value to smooth the earnings (Graham *et al.*, 2005; PwC, 2011). Estimates presented by economists at the Bank of England suggest that projects very often get rejected due to the use of higher discounting rate for future cash flows. Thus, the definition of what is long term in investor outlooks has shortened considerably over time, creating myopic behaviour and a preference for short-term payback rather than long-term value creation (Haldane and Davies, 2011). New regulation in the banking sector and accounting rules for insurance companies and pension funds may add to both short-term and irrational reallocations of asset portfolios[4].

Shareholder value as a guide for institutional investment is also questioned on several grounds; among them, the single-minded focus on shareholder value does not generate shareholder value (Stout, 2012). Thus, shareholder value is argued to be a problem for shareholders. Quiggin (2010) pointed to institutional investor quest for irrationally high returns on the stock market as the cause of lack of funds for long-term investment in infrastructure, which is usually undertaken by governments and financed by debt held by institutional investors.

Some of these academic critiques seem to have affected policy formation. The high-profile group *The European Corporate Governance Forum* now worries that financial market regulation appears to have focused too much, thus far, on providing liquidity instead of encouraging different actors to take a longer-term view. "The trend has been short term. In this light, a critical mass of long-term shareholders is needed. Regulation currently does not promote that, but has rather encouraged trading over ownership. Therefore, one should look into the incentives for shareholders."[5]

In a Green Paper from 5 April 2011, the European Commission claims that the development of the EU regulatory framework, including the Takeover Directive, has worked in favour of short-termism and that this has had a detrimental effect on the value-creative process of the corporation[6]. The UK Kay Review (2012) concludes that "short-termism is a problem in UK equity markets, and that the principal causes are the decline of trust and the misalignment of incentives throughout the equity investment chain" (Kay, 2012, p. 9).

When the International Corporate Governance Network revised its corporate governance principles in 2009, the first lines stated: "The objective of companies is to generate sustainable shareholder value over the long-term." This sheds light on the fact that similar to other investors, institutional investors might be active or passive investors as well as long-term or short-term oriented in their investment approach and that a regulatory framework can be used to promote different kinds of behaviour[7].

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The Kay Review (2012) then sets out principles that are designed to provide a foundation for a long-term perspective in UK equity markets, suggesting being the introduction of a "stewardship code" for institutional investors. This new or renewed thinking has led to some changes in the UK regulatory framework. The UK Panel on Mergers and Takeovers has launched new takeover rules stating that a target company's board opinion on a bid not only is limited to addressing the price currently offered, but also might take other factors that affect other stakeholders into consideration when recommending whether or not shareholders take the offer (tenth version of the Takeover Rules; §25.2: a). In an assessment report on the European Takeover Directive presented to the Commission in 2012, a broader focus on team production rather than shareholder supremacy (Blair, 1995; Stout, 2012) is presented as an alternative view on the stakeholder role of the corporate board[8].

In parallel, there also seems to be a general move among policymakers to move away from quantitative rules to more general qualitative rules of investment for institutional investors. According to Yermo's 2008 review of the Organization for Economic Co-operation and Development (OECD), qualitative rules correspond better to the best practice for public pension funds. G20/OECD presented in September 2014 a list of seven principles to support the long-term investment financing by institutional investors. Among the recommendations stated was that "governments adopt measures incentivising or mandating institutional investors to fulfil their stewardship responsibilities by acting to improve and foster increased corporate value and sustainable growth of investee companies, through constructive engagement or purposeful dialogue, with due regard to their clients and beneficiaries and to investee companies" (Principle 1, p. 9). This includes establishing proper regulations to enhance collaborative activities between long-term owners and the sharing of expertise to enable sufficient scale and diversification to be reached for investments in large, long-term projects (Principle 5, p. 25).

The European Commission has picked up some of these ideas in its proposal for a Shareholder Rights Directive (2014), where one of the main points addresses a perceived need for more long-term and responsible engagements on the part of institutional investors in the governance processes of listed companies.

A report from The UK Law Commission (2014) states that it is in line with prudent investment decisions by pension funds to "[. . .] make investment decisions that are based on non-financial factors, provided that (*i*) they have good reason to think that scheme members share the concern; and (*ii*) there is no risk of significant financial detriment to the fund." (p. 135). This gives an asset manager a certain freedom in fulfilling the role of a "universal owner": for example, when deciding on accepting or refusing a hostile bid offer on an investee company[9].

Many actors thus also pledge the necessity of revising capital requirements by pension funds. Mark-to-market valuation of listed stocks, promoted by the regulatory authorities, works as an incentive for asset managers to prefer passive index investing rather than larger stakes that require more of a long-term commitment.

Summing up, there are indications that institutional investors across Europe may be incentivized to move away from (passive) index tracking investment strategies. We foresee that the effect of such a change will be seen in the years to come. However, in a political perspective, these effects will be interconnected to the development of national governance regimes, domestic company law and the qualitative and quantitative regulation of domestic institutional investors. Although there are some texts critical of shareholder value orientation of corporate governance, European corporate governance generally remains on its present trajectory of reinforced shareholder value orientation. We assume that any changes that would kill off the Quiggin zombies will be politically contested among interested parties. We will properly analyze these interconnections in our next section, in

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which we develop propositions for how modifications of institutional investor mandates may play out in different corporate governance regimes.

5. Contested modification of institutional investment

In a stringent analysis, the contestation over institutional investment revolves around two separate dimensions: investment time horizon *and* definition of corporate value. A shift among institutional investors to more concentrated portfolios and more active roles in corporate decision-making, including joint activities – that is, through "acting in concert" on stock markets – could be potentially related to a shift from shorter- to longer-time horizons in corporate decision-making and increasing the perceptions of economic rationality in the building of corporate governance competence within institutional investor organizations.

Such a shift from shorter- to longer-time horizons may be also related to a shift from shareholder value- to stakeholder (or corporate) value-oriented corporate governance. The question of to whom the institutional investors serve returns at this point. Do they serve investors, management, labour or their own organizational interests? As long as institutional investors are, and are regulated to be, more passive (index tracking) or less passive (active asset allocation), yet are not at all involved in corporate governors in the sense of controlling shareholders, these organizations will not be equipped with governance and managerial competence to engage in a fruitful manner. This could change with the support of a growing number of supranational policy documents; such a change would be of major importance to corporate governance regimes all over the world.

Given this, we find it appropriate to bring to the attention of those in academia as well as practitioners that the institutional investor ideological pendulum might now be swinging toward both less index-tracking behaviour and more socially responsible and sustainable stakeholder corporate governance, where shareholders are seen as one among a number of actors with legitimate claims on corporate decision-making and where shareholders may, in practice, represent something more than an interest in maximum short-term financial return. This means that the entire shareholder value maximization proposition will be contested with the role of shareholders who are focused on liquidity and relative value rather than on long-term and a committed "voice": for example, the hostile bid as a mechanism for corporate governance.

Broadly speaking, it should be appropriate to speculate in a revival for the final position of Berle and Means (1932, p. 312) themselves that "neither the claims of [shareholder] ownership nor those of [managerial] control can stand against the paramount interests of the community": that is, a re-embedding of the economy in the society and the values of its citizens. Stakeholder commitment might supersede shareholder passivism as well as activism.

In Figure 2, we schematically illustrate and summarize this view of the development of corporate governance and control and what it might imply. The figure depicts a typical Western European economy, presented as evolving through three economic epochs each with its own interdependence between the corporations and diverse environments. The particular Western European corporate governance regimes, with its unique laws, rules and traditions, may most directly be explained by the strong civil society movements (e.g. labour unions) in conjunction with centre or left of centre governments. This is the typical coordinated market economy pictured by Hall and Soskice (2001). In a range of countries, corporate control has been in the hands of stakeholders of various kinds – wealthy families, banks, trusts or the state, by the way of tax policy, direct subsidies, differential voting rights, pyramidal shareholding structures and cross-holdings. This can be described as the post-war industrial capitalism period (the first phase) with a governance rationale based on formal or informal agreement between involved actors to enable growth of industrial companies while, at the same time, protecting good quality industrial employment and socio-economic prosperity. To varying degrees across different countries, state retirement

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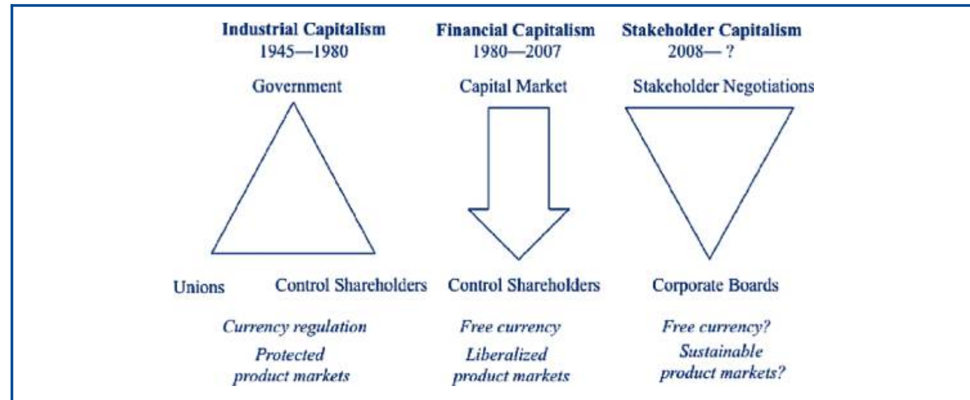
Figure 2 A conceptual model of Continental European corporate governance regimes through three epochs



plans are developed along with collectivist or corporatist agreements in the civil society, thus creating a massive pool of collective, rather than individual, financial savings. Capital flow was limited due to currency regulation and a weak integration of the European financial markets. State, bank or family stakeholder governance dominated with the support of a plethora of protective devices.

With an increasingly integrated European capital and goods market, national corporate governance worked differently in financial capitalism (the second phase). Meanwhile, at the same time, protective devices were challenged, and remain challenged, by European neoliberalism (Horn, 2012). Institutional investors have reduced the exposure to their domestic market and, in a portfolio allocation rationale, reallocated huge capital to foreign markets. Portfolio theory, index tracking, herding and quantitative limits on investments in financial capitalism have reduced the institutional investors' effectiveness as active governors of individual listed firms (along with other private minor shareholders in firms). This wedge between ownership and control has, in turn, fed new categories of shareholders vying for corporate control: such as hedge funds, activist funds, sovereign wealth funds, foreign governments and private equity. The activity level of these actors depends on the structure of the national governance regimes. Countries with corporate law that empowers shareholders end up being easy targets for short-term pressure and minority shareholder activism upsetting previous formal or informal bargains on corporate purpose. Countries with stakeholder empowering corporate law, and more of private household shareholdings, result in the management becoming more entrenched.

We hypothesize that institutional investors re-concentrate portfolios in the third phase, which we refer to as the post-financial crisis period, by committing to the longer-term engagement with individual companies. We call this period *stakeholder capitalism*. This change of investment rationale would be supported by new regulation, new evaluation strategies and new governance structures of institutional investors. Minority protection is pivotal for the institutional investor operational rationality to be modified for specific asset risk absorbance via larger long-term equity stakes. Economical rationality is important for corporate governance regulation, as is political power dynamics, which includes the sense-making processes in various forms of discourse. We, therefore, assert that control-enhancing mechanisms be modified for institutional investors to make significant stakes in individual company shares.

Modifications with direct or indirect impact on corporate governance may come in the form of corporate law, regulations of institutional investor operations and changes in public spending on investment (financed by debt issued to institutional investors). Corporate law may emphasize other objectives besides – or instead of – shareholder value; directors may be held accountable to people other than the shareholders. Institutional investors may be

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given legislative and ideological support for modified investment patterns and degrees of influence in corporate decision-making. Various stakeholders in institutional investor operations (e.g. labour) may be allotted degrees of influence. Finally, governments may choose to reallocate collective capital away from capital markets in the direction of public investments in infrastructure, etc. In the process, prudent asset management would move away from portfolio allocation models in the direction of engagement and sustainability.

With massive amounts of financial capital "up for grabs", any re-regulation of the institutional investor operations might be highly contested among interested parties. This is to be expected. Hence, we offer a number of propositions to stimulate further theoretical elaboration and empirical investigation, based on this assertion and the theoretical idea that investors, managers, labour and institutional investors are important actor categories in the political contestation of institutional investment.

We begin with the notion that market liberal ideology is likely to remain strong in some parts of the world (the USA and the UK are prime examples). Current corporate governance regimes primarily protect investor and managerial interests and support shareholder value maximization as corporate purpose; this may enable them to absorb the impetus from critique by emphasizing the role of corporate directors as stewards of the corporation. Thus:

> *P1*. In countries with strong minority shareholder protection and dispersed shareholdings, and with shareholder value orientation in management ideology, *corporate boards will be subject to more regulation* for long-termism and stakeholder value creation/protection. *In effect, this might lead to greater managerial (or board) control.*

The trajectory may move in various directions in countries where controlling shareholders are effectively in charge of corporate decision-making (for instance, in Mediterranean or Scandinavian countries). We predict that these groupings will contest modifications in institutional investor mandates; the most forceful argument being that all investor organisations are unfit to make corporate decisions due to a lack of competence and/or supposed illegitimate objectives (be it short-termism, job protection, environment protection, human rights activism, gender or racial equality and so on). Conversely, we argue here that it is difficult to prevent institutional investors subject to a global policy push of "responsible" investment from building in-house corporate governance and strategic management competences, as do many private equity firms that institutional investors partly finance. Similarly, a perception of focus on "long-term sustainable value creation" may downplay the political rationale for quantitative limits aimed to protect private investors from political intervention. Thus, the impetus for some form of re-regulation is strong, and we first propose that:

> *P2a*. In countries with weaker minority protection and more concentrated corporate control, institutional investors will be subject to re-regulation conducive to larger equity stakes *or* to fixed-income, real estate and/or illiquid investments.

We argue that the specific shape of the outcome of increased institutional engagement will depend on how various national and supranational polities act differently in relation to private investors that are already on the market. How private investors will react to these new institutional investors will depend on the way in which they are tied to the following: particular firms and business groups and/or groupings of managers and/or groupings of labour in the same firms and/or factions of employees and trustees within institutional investment organizations. Some among these actor categories will in different ways work against the establishment of independent, long-term, large-equity stake and active institutional investors enacting their version of investee company's value creation.

The position of universal owner is quite distinct when compared to other kinds of corporate stakeholders, as Hawley and Williams highlight. Successfully directing corporate governance in line with its "rational" interest, regardless of how it is achieved, will ultimately

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hinge on these organizations' political power. We suggest the notions of "political independence" and "political clout" to denote the level of strength on the part of institutional investors *vis-à-vis* eg. incumbent controlling shareholders.

If unable to lower the barriers to direct impact on corporate decision-making, then institutional investors will find it irrational with regard to their formal duties to continuously build equity stakes and instead opt for enlarged non-equity investments and work for regulatory and ideational transformations in such a direction. For instance, this might entail increased focus on financing government investment expenditure through the acquisition of government bonds. Only where institutional investors are independent and powerful enough will they find it rational in light of their formal duties to challenge incumbent controlling shareholders and/or managers directly, effectively becoming a "new" category of legally and ideationally enabled controlling shareholders. This brings us to two further specifications and more multi-faceted propositions:

P2b. Institutional investors will be subject to re-regulation in the direction of fixed-income securities, real estate and/or illiquid assets in countries where institutional investors are or will become politically independent from controlling shareholders, banks and/or corporate managers.

P2c. Minority protection regulation and control-enhancing mechanisms will be subject to re-regulation in the direction of stronger minority protection and reductions of control-enhancing mechanisms in countries where institutional investors are or will become politically independent from controlling shareholders, banks and/or corporate managers *and* effectively belong to the dominating political bloc (thus, they carry "political clout").

Predicting the scenario, the country, and the implication on the corporate sector, is beyond our scope, as is the perhaps most pressing question of all: How each of these possible developments might affect the macro trajectory of the society and the economy. In terms of the theoretical framework described in Figure 1, our line of reasoning implies a further specification of the category "Outcomes". Shareholder dispersion or blockholding structures alongside levels of minority protection are rather crude categories that cover great variation, in particular in terms of the configuration and re-configuration of institutional investors. We leave the development of these matters to further work.

6. Conclusions and further research

We suggest that we are witnessing a modification in the rationale of institutional investor organizations, spurred by the global financial crisis and the parallel movement towards "engaged" investments, which have a multitude of potential implications for national corporate governance regimes. We argue that any impact on practice related to these shifts implicate two fundamental and different dimensions for institutional investors: investment horizon and the definition of corporate value. We propose that any such implication will be politically contested based on our political perspective on corporate governance regimes. The efficacy of the contestation will depend on the degree of minority shareholder protection and the political strength of private investors in particular national corporate governance regimes.

Although we claim to foresee the possible future, we cannot predict it in great detail. There are a growing number of texts that criticize the shareholder value orientation of corporate governance; general European corporate governance remains on its present trajectory of reinforced shareholder value orientation. What is of importance here, however, is our prediction of little "convergence" in global corporate governance.

There are many other areas of great interest and relevance to a full explanatory narrative of corporate governance regimes: the regulation of bank ownership of mutual funds, taxation on wealth gains, dividends, interest income, international criminal law regarding corporate operations and so on. These are outside the scope of our research. Changing espoused

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ideologies is comparatively easy and has already occurred, while transforming corporate law will be most difficult, as state legal systems are change-resistant, not least because of the power of the legal profession(s) (Teubner, 2001; Coffee, 2006). How easy or difficult it will be to alter institutional investor investment mandates falls somewhere between the two.

We encourage the study of both the modes and consequences of the possibly modifying rationale of institutional investment practice, *without* the "zombie" assumptions described by Quiggin (2010): that market liberalism is superior to every other model of the society and with the assumptions that institutional investor rationality is a highly contested political matter. Furthermore, we promote the understanding that political preferences shift, also as a consequence of academic debate. In this vein, the most challenging task for scholarship is perhaps to operationalize and trace the crucial notions of "political independence" and "political clout". For practitioners of institutional investments across Europe and the rest of the world, the main challenge is to create and maintain that political independence and clout to successfully deliver on their duties.

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Notes

1. For instance, in the US the ERISA Act from 1974 effectively prohibits US pension funds from becoming engaged shareholders.

2. EC "Shareholders" rights directive 2014′; "Proposal for a Directive of the European Parliament and of the Council Amending Directive 2007/36/EC as Regards the Encouragement of Long-Term Shareholder Engagement" and "Directive 2013/34/EU as Regards Certain Elements of the Corporate Governance Statement."; Kay, John. "The Kay Review of UK Equity Markets and Long-Term Decision Making." London: 2012; EU Parlament, "Proposal for a Directive of the European Parliament and of the Council on European Long-Term Investment Funds." 2013/34/EU.

3. Quiggin (2010) accounts both for the lack of empirical support for five "zombie" ideas and points to how the ideas are used to legitimize policies. Apart from the *efficient market hypothesis* and the belief in *privatization*, the ideas of the *great moderation* (a claimed reduction in business cycle amplitudes explained by "a new economy"), *dynamic stochastic general equilibrium* (theoretical frame for macroeconomic analysis based on numerous micro models), and *trickle-down economics* (a claim that tax breaks for the wealthy will eventually be good for the weaker) are dealt with in Quiggin's work.

4. CEPS-ECMI Task Force (2012) "Rethinking Asset Management. From Financial Stability to Investor Protection and Economic Growth." Brussels: Center for European Policy Studies, European Capital Markets Institute.

5. ECGF (European Corporate Governance Forum). "Minutes of the Meeting of 2 June 2011." Quote p. 1.

6. EC (2011). "Green Paper: The EU Corporate Governance Framework." April 5.

7. ICGN (International Corporate Governance Network), 2009, "ICGN Global Corporate Governance Principles: Revised."

8. Extensive reports by CEPS-ECMI Task Force (2012) "Rethinking Asset Management. From Financial Stability to Investor Protection and Economic Growth", Brussels: Center for European Policy Studies, European Capital Markets Institute; and OECD (2012) on "Effect of Solvency Regulations and Accounting Standards on Long-Term Investing."

9. UK Law Commission, "Fiduciary Duties of Investment Intermediaries", London: UK Law Commission, 2014.

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