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Hail Britannia?: Institutional Investor Behavior Under Limited Regulation

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HAIL BRITANNIA?: INSTITUTIONAL INVESTOR BEHAVIOR UNDER LIMITED REGULATION

*Bernard S. Black**
and *John C. Coffee, Jr.***

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I. INTRODUCTION: THE RELEVANCE OF BRITAIN

A central puzzle in understanding the governance of large American public firms is why most institutional shareholders are passive. Why would they rather sell than fight? Until recently, the Berle-Means paradigm -- the belief that separation of ownership and control naturally characterizes the modern corporation — reigned supreme.¹ Shareholder passivity was seen as an inevitable result of the scale of modern industrial enterprise and of the collective action problems that face shareholders, each of whom owns only a small fraction of a large firm's shares.

A paradigm shift may be in the making, however. Rival hypotheses have recently been offered to explain shareholder passivity. According to a new "political" theory of corporate governance, financial institutions in the United States are not naturally apathetic but rather have been regulated into submission by legal rules that — sometimes intentionally, sometimes inadvertently — hobble American institutions and raise the costs of participation in corporate governance.²

The principal policy implication of this new political theory of the American corporation is obvious: deregulate in order to lower the costs of coordination among shareholders. Relaxing various legal restrictions and barriers — including the Glass-Steagall Act's prohibition against combining commercial and investment banking and federal securities rules that chill group formation by institutional investors — would significantly enhance the ability and incentives of institutional investors to monitor corporate managers. This is an important claim, but also one not easily tested.

The new political theory of the corporation has not, however, won universal acceptance. Although agreeing that American institutional investors are in some respects overregulated and thereby chilled from fuller participation in corporate governance, other scholars have doubted that legal restraints can serve as the central pillar of a revised theory of shareholder passivity.³ In contrast to the political theorists, who focus on regulatory barriers that raise the costs of participation in corporate

¹ See ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

² See, e.g., Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990); Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991).

³ See, e.g., LOUIS LOWENSTEIN, *SENSE AND NONSENSE IN CORPORATE FINANCE* 209 - 33 (1991); John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445 (1991).

governance, these critics respond that existing incentives — particularly those of fund managers — are too weak to motivate active institutional monitoring, even if regulatory barriers were reduced.⁴ The attractions (real or imagined) of the exit option of selling into a liquid securities market further reduce the likelihood that even large shareholders will organize to resist management.

The two authors of this article have been on opposite sides of this debate, but both recognize that no single explanation is complete and that other factors, such as the self-interest of fund managers, the conflicts of interest faced by institutions who want to retain corporate business, cultural forces, collective action problems, and what we can call *path dependence* — the difficulty of changing the structure and behavior of highly evolved and specialized institutions — have causal roles in explaining shareholder passivity.⁵ The central question in research on American corporate governance is how these forces interact to produce the characteristic passivity of most American institutions.

The debate between the proponents and critics of a political theory of American corporate governance is in some respects untestable. We cannot run the legal experiment of changing our laws to facilitate institutional oversight of corporate managers and observe how the institutions act. Still less can we go back sixty years or more, change our laws *then*, and see how the institutions would act if they had grown up in a different legal and political environment. In similar settings, however, social scientists have long used "natural experiments" to gain insight into how a particular legal rule affects behavior across otherwise similar societies.⁶ Comparative study of corporate governance in other industrialized countries offers insight into how American corporate governance might have developed under a different legal regime and how governance practices might change if legal rules were changed today.

⁴ Both sides in this debate agree, however, that many regulatory barriers to shareholder collective action should be reduced or removed. See, e.g., John C. Coffee, Jr., *The SEC and the Institutional Investor: A Half-Time Report*, 15 CARDOZO L. REV. 837 (1994).

⁵ For an effort to develop a multicausal statement of the political model, see Bernard S. Black, *Institutional Investors and Corporate Governance: The Case for Institutional Voice*, J. APPLIED CORP. FIN., Fall 1992, at 19, 21-24.

⁶ The best-known — and most controversial — context in which natural experiments have been used to inform a policy debate has been the debate over capital punishment. Scholars have looked to the crime rate in contiguous — and presumably similar — American jurisdictions, one having the death penalty and one not. See, e.g., FRANKLIN E. ZIMRING & GORDON J. HAWKINS, *DETERRENCE: THE LEGAL THREAT IN CRIME CONTROL* 263-70 (1973). Without entering that debate, our approach in focusing on the United Kingdom is similar in nature.

To explore whether the paradigm American corporation, with its strong managers and widely dispersed shareholders, could be a product of American politics and the path-dependent evolution of American financial institutions, scholars have recently examined corporate governance in Japan and Germany, where commercial banks and, to a lesser extent, insurance companies control large equity stakes and sometimes closely monitor managements.⁷ The merits of these bank-centered systems, compared to more market-centered systems (such as those in the United States and the United Kingdom), and the transportability of bank-centered monitoring to other cultures and economic environments, have fueled a stimulating debate that will occupy corporate law scholars for some time to come.

At this point, our interest in the United Kingdom begins to come into focus. The role of financial institutions in corporate governance in the United Kingdom has attracted much less attention than the role of German and Japanese banks.⁸ Yet the United Kingdom has unique advantages for the effort to put American corporate governance in comparative perspective and to understand how it might be improved and what role legal rules and other factors play in shaping our system of corporate governance. The legal culture of Britain is as similar to our own as we are likely to find; in Britain, like the United States and unlike most of the rest of the world, most large corporations are public and *not* family-controlled; the United Kingdom has long had a liquid securities market; the British "City" has the same array of financial institutions that we do (commercial banks, insurers, mutual funds, investment banks, private and public pension funds); stock ownership in both Britain and the United States has come in the last few decades to be dominated by institutions; and, most centrally, financial institutions in the United

⁷ See, e.g., W. CARL KESTER, JAPANESE TAKEOVERS: THE GLOBAL CONTEST FOR CORPORATE CONTROL 53 - 81 (1991); Richard M. Buxbaum, *Institutional Owners and Corporate Managers: A Comparative Perspective*, 57 BROOK. L. REV. 1 (1991); Coffee (1991), *supra* note 3; Ronald J. Gilson & Mark J. Roe, *Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization*, 102 YALE L.J. 871 (1993); W. Carl Kester, *Governance, Contracting, and Investment Horizons: A Look at Japan and Germany*, J. APPLIED CORP. FIN., Summer 1992, at 83; Mark J. Roe, *Some Differences in Corporate Structure in Germany, Japan, and the United States*, 102 YALE L.J. 1927 (1993).

⁸ Professor Paul Davies is an exception. See Paul L. Davies, *Institutional Investors: A U.K. View*, 57 BROOK. L. REV. 129 (1991); Paul L. Davies, *Institutional Investors in the United Kingdom*, in INSTITUTIONAL INVESTORS AND CORPORATE GOVERNANCE 257 (Theodor Baums, Richard M. Buxbaum & Klaus J. Hopt eds., 1994). See also JONATHAN P. CHARKHAM, KEEPING GOOD COMPANY: A STUDY OF CORPORATE GOVERNANCE IN FIVE COUNTRIES 248 -343 (1994). We have each considered corporate governance in the United Kingdom briefly in earlier work. See Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895, 927-31 (1992); Coffee (1991), *supra* note 3, at 1309 -11.

Kingdom are significantly less regulated than their American counterparts — though *less* regulated does not mean *unregulated*. In particular, Britain has no counterpart to the Glass- Steagall Act or to U.S. restrictions on interstate banking, which limit the size and power of American banks. Nor does it have our history of limiting stock ownership by insurance companies or regulating collective shareholder action.

Not only is the United Kingdom context similar to that of the United States, but British patterns of corporate governance may foreshadow future developments in the United States. The U.K. equities market is considerably more institutionally dominated than the U.S. stock market. U.K. institutions hold about two-thirds of all publicly traded British stocks, while U.S. institutions only hold around half of U.S. publicly traded stock.⁹ Shareholder concentration is also higher. The twenty-five largest institutional shareholders hold an absolute majority of the stock of many U.K. companies.¹⁰ For smaller U.K. firms, the five largest institutional holders control 30% or more of the shares. Prudential Corporation PLC, the largest British institutional investor, alone holds about 3.5% of the entire British equity market.¹¹ Several other institutions are almost as large. Equally important, the world of British institutional investors is close-knit. Communication among them is easy and unregulated. This reduces the coordination costs and free rider problems that plague collective action in the United States. In short, Britain presents a model of what U.S. securities markets might look like if U.S. institutional holdings continue to grow — and with many fewer legal barriers to institutional investor participation in corporate governance.

To understand the behavior of British institutional investors, we relied partly on traditional written sources. But British institutions typically act behind closed doors. Only a handful of exceptional cases degenerate into a public battle between shareholders and managers. To probe this hidden world of informal monitoring, we conducted a series of interviews with senior officers in major British institutions.¹²

⁹ For British data, see HER MAJESTY'S STATIONERY OFFICE, ECONOMIC TRENDS NO. 466, THE 1992 SHARE REGISTER SURVEY (1992) [hereinafter 1992 SHARE REGISTER SURVEY]. For the United States, see *Financial Assets & Equity Holdings*, BRANCATO REP. ON INSTITUTIONAL INVESTMENT (Victoria Group, Inc., Fairfax, Va.), Dec. 1993, at 42 tbl. 11.

¹⁰ See Tony Jackson, *The Institutions Get Militant*, FIN. TIMES, June 11, 1991, at 18.

¹¹ See R.E. Artus, *Tension to Continue*, in CREATIVE TENSION? 12, 12 (National Assn. of Pension Funds, Ltd., 1990).

¹² These interviews were conducted principally in the summer of 1992 and were arranged with the very helpful assistance of Jonathan Charkham. Until his recent retirement, Mr.

So what happens in this brave new world of limited regulation and lower coordination costs? One central conclusion is that if Japan and Germany show how American corporate governance might have developed very differently under different legal rules, Britain shows how American corporate governance might not look drastically different under more limited regulation. Major British institutions intervene to change management, but only a handful of times per year. Absent a crisis, the institutions generally stay on the sidelines.

Legal rules do matter. British institutions are significantly more active than their American counterparts. One likely reason is that American institutions cannot act jointly *and quietly*, in the preferred British pattern. In addition, poison pills, control-person liability, and other barriers chill and often prevent American institutions from forming coalitions, even in public. But differences in regulation alone cannot adequately explain the British mix of institutional activism and passivity. The costs of collective action remain considerable, money managers' interest in governance issues varies widely, and the alternative of exit by selling shares into the market remains demonstrably on money managers' minds. Money managers typically intervene only when doing so will improve their *relative* performance — when it will benefit their portfolio more than their competitors'. Conflicts of interest cause some money managers to shrink from open confrontation with corporate managers. (British law does even less than U.S. law to control these conflicts.) Ultimately, only a multifaceted explanation can capture the complex environment in which institutional investors function in Great Britain.

Path dependence in the evolution of financial institutions may be particularly important in understanding national differences in corporate governance systems. Institutional behavior is significantly influenced by

Charkham was the Bank of England's in-house adviser on corporate governance matters. Due to promises of confidentiality, we cannot directly quote or identify the sources of specific comments on which we rely below. Among the fund managers and investment personnel interviewed were: Huw M. Jones, chief investment officer at Prudential Portfolio Managers (Britain's largest institutional investor); L.E. (Paddy) Linaker, chief executive of M&G, probably the most activist British mutual fund family; Paul Myners, chief executive at Gartmore Investment, currently the largest U.K. money manager; Charles Nunneley, the chief executive at Robert Fleming Asset Management; E. Michael Sandland, chairman of the Institutional Shareholders' Committee and chief investment officer for Norwich Union, a large insurer; and Dr. Paul Whitney, chief investment officer of CIN Management, which is the in-house fund manager for the British coal pension funds. All were interviewed in face-to-face meetings by Professor Coffee, except for Sandland, who was interviewed by telephone. For a recent newspaper account, describing several of these individuals as among the most significant actors in the British institutional investor community, see Patrick Weever & Topaz Amore, *Corporate Assassins: poor performers beware, the institutions are gunning for you*, SUNDAY TELEGRAPH, Oct. 17, 1993, City Section, at 5 (listing recent instances in which chief executives have been replaced as the result of institutional activism).

the manner in which classes of institutions have evolved within a particular country. For example, securities firms have different organizational cultures, time horizons, and human capital than commercial banks. The trading culture that develops in these firms places greater emphasis on exploiting short-term market movements than does the culture within a commercial bank, which is typically oriented toward longer-term monitoring. In this light, it is relevant that British securities firms are among the largest pension managers. Had pension management instead developed as an offshoot of commercial banking, pension managers might have adopted the longer time horizons and greater interest in monitoring that banks generally exhibit.

To give another example, British banks invest a trivial percentage of their assets in common stocks. Although there are several explanations for why British banks shun investing in corporate equity, their institutional history again may be instructive. Until well into this century, British regulatory policy discouraged banks from growing too large or owning sizable equity stakes. In contrast, government policies in Japan and Germany encouraged the emergence of dominant national banks and the establishment of close ties between banks and industrial companies. This difference in history could partly explain why British banks remain uninterested in holding equities, even though regulatory obstacles to large equity holdings have been relaxed for some time.

In short, having developed one set of organizational skills under one set of legal and political constraints, financial institutions are not so malleable as to develop new skills quickly — at least unless they expect substantial gains from the change. This leads to a further prediction: A rapid increase in institutional activism would require the visible success of a first mover, who engages in a high level of monitoring and achieves a substantial payoff in portfolio performance. Such a success story might cause institutions that now have a trading orientation to make the investments in human capital and organizational redesign that would let them compete with the first mover. Absent such a visible success, change is likely to be gradual and incremental. This has been both the American and the British pattern to date.¹³

¹³ An obvious example of how a successful first mover can influence the financial industry is the success of Kohlberg, Kravis, Roberts, & Co. and Forstmann Little & Co. in financing leveraged buyouts (LBOs) in the early 1980s. The huge profits of the first movers inspired a number of major investment banks to enter the LBO business, which involves intensive oversight of managerial decisionmaking at a limited number of portfolio companies. But for most investment banks, copying proved difficult. For Drexel Burnham and First Boston, LBOs became a path not to profit but to huge losses.

Although the British experience suggests limits on what legal reform can do to encourage institutional oversight in the United States, it also suggests that some feared dangers of greater institutional oversight are exaggerated. For example, we find no evidence that British institutions "micro-manage," meddle in day-to-day business decisions, collude with each other to take advantage of minority shareholders, foment price-fixing conspiracies, use their influence to extract special concessions from corporations, or intervene in well-run firms. On the contrary, institutional attention is a scarce resource that is allocated mostly to problem firms.

The British experience also reinforces the danger of generalizing about institutional investors. We need to understand each type of institution separately, to assess the likely degree of institutional involvement in corporate governance. British insurers are active, and British pension funds are becoming active. Yet British banks are uninterested in stock ownership. Although a few British mutual funds are active monitors, most behave more like American mutual funds than like British insurers. The multiplicity of institutions complicates the comparative inquiry and makes our conclusions more tentative, but there is no alternative.

We also find signs that the internationalization of capital markets is leading to convergence in institutional investor behavior between the United States and the United Kingdom — and perhaps more generally. For example, some American institutions, having observed the common British practice of separating the positions of chairman and chief executive officer, are prodding American firms to take similar steps, with some success.¹⁴ British institutions, having observed the prevalence of audit committees and the dominance of outside directors on American boards, are pressing for similar changes in British firms.¹⁵ Many British institutions are also adopting the American practice of regularly voting one's shares — and not always for management.

Our conclusion that moderate legal deregulation will produce increased activism but will not — for better or worse — revolutionize the behavior of American financial institutions is not far from the conclusion that a British task force recently drew, after studying the United States, Japan, Germany, and France:

¹⁴ See, e.g., Gilbert Fuchsberg, *Chief Executives See Their Power Shrink*, WALL ST. J., Mar. 15, 1993, at B1.

¹⁵ See OXFORD ANALYTICA LTD., BOARD DIRECTORS AND CORPORATE GOVERNANCE: TRENDS IN THE G7 COUNTRIES OVER THE NEXT TEN YEARS 62 (1992) (describing increased use of nonexecutive directors by large British firms); see also *infra* section II.B.4 (discussing the efforts of PRO NED, the British Committee for the Promotion of Non-Executive Directors).

[I]t is very doubtful whether the structure of the UK financial system could be fundamentally changed. An examination of the origins of systems of industrial finance shows them to be largely the product of historical development; and targeted Government policy has played only a minor role in the establishment of present day systems. Each country's system has developed . . . [in response to] . . . the historical and social structures of each country. . . . Any policy prescriptions for the UK must be of a kind that can be built upon the existing system of industrial finance.¹⁶

The implausibility of radical change does not mean that the more modest change that legal reform might bring is unimportant. On the whole, British institutional investors are considerably more interested in corporate governance than most American institutions. Moreover, the expectation of oversight is embedded in British culture. If the British system does not work flawlessly, we think it works better at effecting managerial changes and making boards of directors sensitive to shareholder desires than do current practices in the United States. Significant efficiency gains seem obtainable if American institutions were more willing to press for change at troubled firms, in the way that British institutions now do.

If the British model has some advantages, how do we get there from here? We have relatively few answers to this critical question and a strong sense that institutional structures are not easily transportable. Radical transformation of our financial institutions is unlikely, even in the absence of legal restrictions. For example, the British banks' lack of interest in holding equities suggests that U.S. commercial banks, even if deregulated, would not evolve into activist monitors. On the other hand, American public pension funds, mutual funds, and insurers — probably in that order of importance — could play a more constructive corporate governance role, and Britain's experience suggests that legal reforms that reduce barriers to institutional coalition formation would yield measurable results.

Looking at Britain, we see a basis for tempered optimism about the future of corporate governance in the United States. Institutional oversight of corporate managers, both directly and indirectly through boards of directors, can be improved. But, as we have suggested elsewhere, a variety of legal reforms are necessary if institutional oversight is to approach its potential.¹⁷ At the same time, shareholder

¹⁶ CBI (CONFEDERATION OF BRITISH INDUS.) CITY/INDUS. TASK FORCE, INVESTING FOR BRITAIN'S FUTURE 32 (1987) [hereinafter CBI TASK FORCE REPORT].

¹⁷ See Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 813 (1992); Bernard S. Black, *Next Steps in Corporate Governance*

oversight needs supplementation by other constraints, including the capital markets, the market for corporate control, the incentives provided by management stock ownership, and fiduciary duties. Institutional oversight is no more the magic bullet that will solve the performance shortfalls of our major firms than takeovers proved to be in the 1980s.

II. A PROFILE OF THE BRITISH INSTITUTIONAL MARKETPLACE

We begin our study of the role of institutional investors in British corporate governance with a survey of the major players — the principal institutions, industry trade groups, and other bodies who define the corporate governance landscape. We note, however, an important caveat. Even more than in the United States, institutional investors in Britain overlap conventional categories. There, as here, mutual funds and insurers manage substantial pension assets. Moreover, Britain has few of the regulatory firewalls that, in the United States, separate mutual funds from insurers and commercial banks, and commercial banks from investment banks. Insurers often run a separate mutual fund business and vice versa; most commercial banks have investment banking subsidiaries.

A. *The Institutions*

British firms, like their U.S. and Japanese counterparts, have undergone a tremendous shift since World War II from individual ownership of shares to institutional ownership. As late as 1957, British financial institutions held only 18% of all British common stock (ordinary shares in British parlance); this had grown to 60% by 1980 and has remained roughly constant since then. Foreign holdings, which are another 13% of the market, are also largely institutional holdings. A breakdown by type of institution is shown in Table 1.¹⁸

Reform: 13D Rules and Control Person Liability, J. APPLIED CORP. FIN., Winter 1993, at 49; Bernard S. Black, *Next Steps in Proxy Reform*, 18 J. CORP. L. 1 (1992); Black (1990), *supra* note 2; Coffee (1994), *supra* note 4; Coffee (1991), *supra* note 3.

¹⁸ Table 1 is adapted from 1992 Share Register Survey, *supra* note 9. Other data sources include RICHARD J. BRISTON & RICHARD DOBBINS, *THE GROWTH AND IMPACT OF INSTITUTIONAL INVESTORS* 139 exh. 13 (Institute of Chartered Accountants 1978) (reporting 1957-1970 data); Erik Berglöf, *Capital Structure as a Mechanism of Control: A Comparison of Financial Systems*, in *THE FIRM AS A NEXUS OF TREATIES* 237, 249 (Masahiko Aoki, Bo Gustafsson & Oliver Williamson eds., 1990) (reporting London Stock Exchange data for 1980). For Japanese data, see JAPAN SECURITIES RESEARCH INST., *SECURITIES MARKET IN JAPAN 1992*, at 68 tbl. 9 (1992) (reporting that individual ownership declined from 61% in 1950 to 23% in 1989, while financial

TABLE 1
OWNERSHIP OF BRITISH EQUITIES, 1963-1992

<i>Type of Shareholder</i>	<i>Percentage Ownership</i>		
	<i>Dec. 31, 1963</i>	<i>Dec. 31, 1981</i>	<i>Jan. 1, 1992</i>
Insurers	10.0	20.5	20.7
Pension Funds	6.4	26.7	31.1
Mutual Funds	1.3	3.6	5.7
Other Financial Institutions	11.3	6.8	2.8
Banks	<u>1.3</u>	<u>0.3</u>	<u>0.2</u>
All U.K. Financial Institutions	30.3	57.9	60.5
Nonfinancial Companies	5.1	5.1	3.3
Foreign	7.0	3.6	12.8
Non-Profit Entities	2.1	2.2	2.2
Government	1.5	3.0	1.2
Individuals	54.0	28.2	20.0

Below we describe each major type of institution and its share of the total equity market. It is easiest to begin with a scorecard. As of mid-1991, the twenty-five largest institutional investors were:¹⁹

institution ownership grew from 24.5% to 48%).

¹⁹ See Fiona Walsh, *Sweeping Out the Boardrooms*, SUNDAY TIMES (London), June 16, 1991, § 4, at 9.

TABLE 2
THE TOP 25 BRITISH INSTITUTIONAL INVESTORS

No.	Company	Type	Asset Under Management (£ billions)
1.	Prudential Corporation	Insurance	57.7
2.	Mercury Asset Management	Merchant Bank	56.3
3.	Barclays de Zoete Wedd	Merchant Bank	46.0
4.	Robert Fleming Holdings	Merchant Bank	45.3
5.	Invesco MIM	Investment Manager	38.6
6.	Schroeder Investment Mgmt.	Merchant Bank	36.3
7.	Standard Life	Insurance	32.2
8.	Postel Investment Mgmt.	Investment Manager	32.0
9.	Lloyds Bank	Commercial Bank	28.4
10.	Baring Investment Mgmt.	Merchant Bank	25.9
11.	Commercial Union	Insurance	25.7
12.	Midland Montagu Asset. Mgmt.	Merchant Bank	24.1
13.	Norwich Union Life Insurance	Insurance	24.0
14.	Legal & General	Insurance	24.0
15.	Royal Insurance	Insurance	23.7
16.	NM Rothschild Asset Mgmt.	Merchant Bank	22.3
17.	County Investment Mgmt.	Merchant Bank	22.3
18.	Friends Provident Life	Insurance	20.5
19.	Natl. Coal Board Pension Fund	Pension Fund	19.8
20.	Scottish Widows Fund & Life	Insurance	19.4
21.	Guardian Royal Exchange	Insurance	19.2
22.	Eagle Star Holdings	Insurance	19.0
23.	Sun Alliance	Insurance	17.0
24.	Kleinwort Benson Inv. Mgmt.	Merchant Bank	15.5
25.	Trustee Savings Bank	Merchant Bank	15.3

The central message from Table 2 is that the structure of institutional investment in the United Kingdom rests on retirement savings. Most of the merchant banks and investment managers listed above principally manage pension money. Only two of the ten largest firms are insurance companies — and insurers also manage pension accounts and sell investment products designed for retirement savings.

1. *Insurance Companies*

British insurers, like Japanese and German insurers,²⁰ hold large

²⁰ Japanese insurers held 17.3% of all Japanese equities in 1990, an insignificant change from 17.5% in 1981. Jun Shirota, *Why was the Japanese Stock Price Level High in the mid 1980s?: A Money Supply Hypothesis*, 182 SHOKEN KEIZAI, Dec. 1992, at 27, 39 tbl. 4. German insurers held 10.6% of German equities in 1990. Kester (1992), *supra* note 7, at 90. On the large equity holdings of Allianz A.G. Holding, Germany's largest insurer, see David Waller, *Allianz*

equity positions for their own account. In 1989, for example, British insurers held common stock with a market value equal to 23% of their total assets, a percentage that has fluctuated with market prices but otherwise shown no apparent trend since 1965.²¹ Insurance companies long were the largest single type of British institution in terms of their equity holdings; they are now second in size to pension funds. As Table 1 shows, insurers' share of all equities has grown, from 10% in 1963 to 21% in 1992. But pension fund holdings have grown even faster, from 6% in 1963 to 31% in 1992.

The prominent role of British insurers is in sharp contrast to that of American insurers. In 1990, the twenty largest American life insurers had only 3.6% of their "common account" assets — assets held for the insurer's own account — in common and preferred stock.²² As a result, in 1992, American insurance companies — life insurers and property/casualty insurers combined — held only 2.4% of American equities.²³

In addition to their direct holdings, British insurers, like their American counterparts, manage large amounts of pension assets, though we lack good data on exactly how much. British insurers were once the dominant managers of pension assets.²⁴ But, as Table 2 shows, they have lost market share to merchant banks and independent money

disclosure helps clear fog, FIN. TIMES, Oct. 8, 1993, at 24.

²¹ See BRISTON & DOBBINS (1978), *supra* note 18, at 127 exh. 5B, 128 exh. 7 (reporting that between 1966 and 1975, insurer holdings of common stock varied between 20% and 27% of assets measured at book value and between 14% and 44% of assets measured at market value; 1975 market value share is 26%); CENTRAL STATISTICAL OFFICE, FINANCIAL STATISTICS 89-90 tbl. 7.10 (Dec. 1991) (reporting data for 1988 and 1989); CENTRAL OFFICE OF INFO., REFERENCE PAMPHLET NO. 133, INSURANCE IN BRITAIN 23 (1979) [hereinafter INSURANCE IN BRITAIN] (reporting that 29% of insurer assets were invested in common stock in 1977, based on book value).

²² See Carolyn K. Brancato, Institutional Investors: A Widely Diverse Presence in Corporate Governance tbl. 9 (Feb. 25, 1993) (working draft, Columbia Univ. School of Law Ctr. for Law & Economic Studies, Columbia Institutional Investor Project). There are some inconsistencies in Brancato's data. She reports that the entire life insurance industry held 9.1% of its assets in common and preferred stock in 1990. This percentage is far higher than the 3.6% average for the top 20. Yet the top 20 insurers held over half of all industry assets. Our judgment is that the top-20 figure, which is derived from company-by-company data, is more likely to be accurate and that the higher percentages for the entire industry probably include some managed assets. The British data could suffer from similar confusion between direct and managed holdings. The data in Table 2 includes managed holdings.

²³ See *Financial Assets & Equity Holdings* (1993), *supra* note 9, at 47.

²⁴ See LESLIE HANNAH, INVENTING RETIREMENT: THE DEVELOPMENT OF OCCUPATIONAL PENSIONS IN BRITAIN 73 (1986) (reporting that insurers had "built up a commanding market lead" in pension fund management in the 1950s, but thereafter suffered "increasingly tough competition" from a new "specialist pension profession" that could handle the administrative details and a new "investment management" profession that could manage the funds).

managers. British insurers also manage mutual funds, a business denied to American insurers by law.²⁵ Once again, we lack data on the size of insurers' mutual fund business.

The British insurance industry is highly concentrated. Prudential, the single largest British institutional investor, owns over 3.5% of the entire British stock market.²⁶ This dwarfs U.S. institutions, the largest of which manages under 1.5% of all equities (with voting power even lower). Indeed, in percentage terms, the largest American institutions would not even make the British top ten.²⁷

A closer look at Prudential conveys a better sense of the monitoring capability of these large institutional investors. Prudential Portfolio Managers Limited (PPM), Prudential's principal investment subsidiary, manages a total portfolio of £45 billion, half of which is held for external clients — chiefly pension funds. Of this portfolio, 43% (£19 billion) is invested in U.K. equities. PPM estimated for us that at any one time it held approximately 900 U.K. stocks. Its holdings included "virtually every" corporation in the 100 largest British corporations, a group that accounts for 70% of the capitalization of the British stock market. PPM commonly holds a substantial stake in even the largest British corporations. PPM estimated for us that it held a 5% or greater stake in "probably 200 companies." When we asked how high they would go in percentage ownership, its senior management acknowledged that it "gets cautious at 10%," but currently held stakes of up to 14%. Concern about illiquidity — being "locked in" in its parlance — was the principal reason expressed for usually stopping at or near 10%.

One plausible reason why British, Japanese, and German insurers hold more common stock than American insurers is that American insurance regulation long forbade, and continues to restrict, American insurers from holding large equity stakes.²⁸ The British have nothing comparable. Instead, the British system is based on " 'freedom with publicity' — freedom for the insurers to determine their own . . . investment and other policies in return for publicity about their financial condition."²⁹ Government Actuary's Department regulations require that an insurer's assets, valued at *market*, equal 104% of liabilities. Insurers

²⁵ See Mark J. Roe, *Political Elements in the Creation of a Mutual Fund Industry*, 139 U. PA. L. REV. 1469, 1471-78 (1991).

²⁶ See Artus (1990), *supra* note 11, at 12.

²⁷ For a survey of the largest American institutional investors, see *II 300: America's Top Money Managers*, INSTITUTIONAL INVESTOR, July 1993, at 105.

²⁸ See Mark J. Roe, *Foundations of Corporate Finance: The 1906 Pacification of the Insurance Industry*, 93 COLUM. L. REV. 639 (1993).

²⁹ INSURANCE IN BRITAIN (1979), *supra* note 21, at 37.

must meet this test assuming a 25% fall in equity values. But equities are not disadvantaged compared to other risky investments. The 104% test must also be met assuming a 25% fall in the value of real estate holdings and a 3% rise in interest rates (which will reduce bond values). Moreover, regulators have been flexible in market downturns. They informally relaxed the 25% test in mid-1992 when a bear market brought some insurers close to regulatory minimums, so that the insurers would not have to dump stocks to meet the solvency test.³⁰

British insurers are, on the whole, long-term investors. The annual turnover rate for life insurers was roughly 15% per year in 1986, and was below 10% as recently as 1980.³¹ In contrast, the *average* U.S. institutional investor turns over its portfolio nearly once per year.³² Only a limited number of heavily indexed U.S. pension funds and a few exceptional U.S. money managers have turnover rates as low as the typical British insurer.³³ Moreover, British insurers rarely sell a major position completely. If Prudential or Legal & General Group PLC, another large British insurer, is a major shareholder today, it will probably remain so for the foreseeable future. Thus, British firms know that such a shareholder is a more or less permanent monitor.

2. Pension Funds

In Britain, as in the United States, pension funds have become the largest single category of institutional investor, soaring from 3% of the market in 1957 to 31% in 1992.³⁴ Both the United States and Britain

³⁰ See Norma Cohen, *New ratios offer a reprieve to equities: The effect of relaxing portfolio margins*, FIN. TIMES, Aug. 15, 1992, at 4. British insurers are also subject to European Community minimum capital rules, but the regulations are not unduly strict. So far as we can tell, common stock, *valued at book value*, counts toward the required minimum capital in the same way as any other asset. The book value approach increases insurers' ability to hold common stock. They will not violate the solvency rules simply because equity prices have dropped, as long as prices recover before the stock must be sold or losses can be offset by also taking profits on other holdings. For an overview of EC insurance regulation, see INSURANCE IN BRITAIN (1979), *supra* note 21, at 41.

³¹ See CBI TASK FORCE REPORT (1987), *supra* note 16, at 22.

³² See LOUIS LOWENSTEIN, *WHAT'S WRONG WITH WALL STREET: SHORT-TERM GAIN AND THE ABSENTEE SHAREHOLDER* 63-68 (1988) (noting an average annual turnover of 87% for all U.S. equities, with institutional turnover higher still).

³³ See, e.g., Dale M. Hanson, *The Long-Term Perspective: One Institutional Investor's Point of View*, Address at the Current Investment Issues Seminar (Sept. 23, 1992) (transcript on file with authors) (reporting that CalPERS has annual turnover of about 10% for the 80% of its portfolio that is indexed). Note, however, that if the nonindexed 20% of CalPERS' equity portfolio turns over at 100% per year, CalPERS total turnover would still be 28% [(0.10 × 0.80) + (1.00 × 0.20) = 0.28].

³⁴ For 1957 data, see BRISTON & DOBBINS (1978), *supra* note 18, at 139 exh. 13. For 1992 data, see Table 1.

have large corporate pension plans, fueled by legal requirements for minimum funding and tax exemption for pension benefits. The British have no strict analogue to our multiemployer pension funds, nor to our public pension funds. Most public employee pensions are unfunded. The principal British analogues to American public pension funds are the large quasi-public plans covering the employees of formerly nationalized industries, such as the £20 billion coal miners' plan run by CIN Management and the Post Office and British Telecommunications pension funds, which total £32 billion and are administered by Postel Investment Management. In 1980, quasi-public plans held about 29% of all pension plan assets, suggesting that they currently hold about 9% of British equities.³⁵ In contrast, Germany and Japan have minimal pension fund assets.³⁶

a. Corporate pension plans. Apart from funding rules, British pension plans have been relatively unregulated. Pension plans are set up as trusts, with the trustees governed principally by the common law of trusts. This lets company officers pick the pension plan trustees. Often, as in the United States, they pick themselves. British pension plans use a mixture of inside and outside money managers. The trend, though, is in the direction of outside managers, as suggested by the dominance of pension fund managers among the largest investors.³⁷

Corporate pension plans in Britain, like their American counterparts, are relatively passive. But their passivity is not absolute. Outside money managers face a tension between maximizing returns and a conflict-of-interest- driven desire to keep a low profile with regard to shareholder activism. Faced with a bad investment, they may quietly support another major shareholder that takes the lead role in pressing for

³⁵ See RICHARD L. DEATON, *THE POLITICAL ECONOMY OF PENSIONS: POWER, POLITICS AND SOCIAL CHANGE IN CANADA, BRITAIN AND THE UNITED STATES* 242 (1989).

³⁶ In Germany, high government-funded retirement benefits leave less need for corporate pension plans. The government plans are not funded. See Buxbaum (1991), *supra* note 7, at 10. Until recently, most Japanese corporate pensions were unfunded. Recently adopted funding requirements, however, imply that Japanese pension plans will become important over the next couple of decades. Conversation with Dr. Hiroo Hojo, Senior Economist, Japan Securities Research Institute (Feb. 26, 1993). We are not aware of data on the size of funded Japanese pension plans. Cf. JAPAN SECURITIES RESEARCH INST. (1992), *supra* note 18, at 8-9 (not treating pension funds as a separate type of financial institution). Funded pension trusts administered by banks held an estimated 0.9% of Japanese equities in 1989. *Id.* at 10 tbl. 3.

³⁷ The relatively unregulated state of British pension plans will likely change in the wake of the Robert Maxwell scandal, in which Maxwell looted corporate pension plans to fund his firms' operating losses. See, e.g., Bronwen Maddox, *Like a thief taking \$2B in the night*, FIN. POST, June 17, 1992, § 1 at 6. Some proposals, such as making at least some of the trustees independent of the plan sponsor, see *Protecting Pensions*, ECONOMIST, Nov. 14, 1992, at 15, will increase the fund's independence and may lead to pension plans' becoming more active in corporate governance issues.

a change in strategy or management, happily sell their shares to a takeover bidder, or take joint action that they would not take individually, perhaps through the industry trade group, the National Association of Pension Funds, Ltd. (NAPF). In some cases, outside money managers will urge a change behind the scenes, a rarity in the United States.³⁸

b. Quasi-public pension plans. In the United States, public pension plans, and quasi-public plans like the College Retirement Equities Fund (CREF), have been by far the most active institutions in the corporate governance realm.³⁹ The incentives of public fund managers to be active monitors of corporate managers remain uncertain. Public fund managers have weaker conflicts of interest than other institutions in opposing corporate managers. But their incentives to monitor corporate managers are limited. Public fund managers do not directly profit if the fund earns a higher return. Many are heavily indexed, and thus will match the market whatever they do. Although public fund managers point to their fiduciary duty as the justification for their activism, some outside observers worry that political motives, including the desire for favorable publicity, underlie some public fund activism.⁴⁰

The British example only deepens the puzzle. Traditionally, British quasi-public employee pension funds have not been among the most active shareholders. Although the Railway, Coal, and Postel plans have been prominent in the recent British interest in American-style proxy activism,⁴¹ they are less central in the behind-the-scenes oversight that is more typical of British institutional efforts to date.⁴²

³⁸ See, e.g., *Shareholders Taste Blood at Westinghouse, IBM, and American Express*, CORP. CONTROL ALERT (American Lawyer Media, New York, N.Y.), Mar. 1993, at 1, 4 ("[P]rivate money managers ... made a rare appearance ... when James Robinson tried to hang on as chairman of the board of [American Express]").

³⁹ See generally Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795 (1993).

⁴⁰ For discussion of the incentives and motives of American public fund managers, see, for example, WILLIAM M. O'BARR & JOHN M. CONLEY, *FORTUNE AND FOLLY: THE WEALTH AND POWER OF INSTITUTIONAL INVESTORS* 175-205 (1992); Black (1992), *supra* note 17, at 878-81; Coffee (1994), *supra* note 4, at 857-71; Romano (1993), *supra* note 39.

⁴¹ Telephone Conversation with Howard Sherman, Director, Institutional Shareholder Services' Global Proxy Advisory Service (Mar. 25, 1993); see Richard A. Melcher & Patrick Oster, *Yankee-Style Activists Strike Boardroom Terror Abroad*, BUS. WK., Mar. 15, 1993, at 74, 75 (Alastair Ross Goobey, CEO of Postel Investment Management, explains: "We see ourselves playing a policeman's role."); Margaret Price, *Governance Efforts Expanding to U.K.*, PENSIONS & INVESTMENTS, Sept. 30, 1991, at 3, 31 (noting that South Yorkshire Pensions Authority Superannuation Fund joined a campaign to force Fisons PLC, a chemical and fertilizer manufacturer, to change its method of peat harvesting in Yorkshire).

⁴² Our interviews with the two largest quasi-public pension advisers — Postel and CIN Management, which manages the British Coal Pension Funds — suggest that they are eager to join

3. *Mutual Funds*

Mutual funds are the third major British category of institutional investor. British "investment trusts" and "unit trusts" correspond roughly to American closed-end and open-end mutual funds, respectively. The two together owned an estimated 11% of British equities in 1990, up from about 6% in 1957, though not much changed since 1972.⁴³ This is similar to American mutual funds, which owned an estimated 10% of U.S. equities in 1993.⁴⁴ In contrast, Japanese and German mutual funds are unimportant as institutional shareholders.⁴⁵

There are sharp differences between mutual funds in their involvement in corporate governance. Many British mutual funds are largely passive. On the other hand, M&G Group, which is principally a unit trust manager, is sometimes held out as a model of mutual fund behavior. In 1992, M&G held 5% or greater stakes in 250 public companies.⁴⁶ M&G explains that its corporate philosophy includes long-term investing and active dialogue with corporate managers:

We believe strongly that, as an institutional investor, we should have a constructive dialogue with the management of companies in which we have a significant interest We take a long term view of performance and we are not deflected by short term considerations. We do not attempt to tell management how to run their businesses, but, if a company's actions seem likely to jeopardise the interests of shareholders, we find that constructive intervention can often be preferable to disposing of our holding.⁴⁷

In an interview with us, a senior M&G official estimated that it saw the typical company in its portfolio two to three times a year. Still, because M&G holds roughly 700 stocks, it can scarcely monitor each portfolio company with probing intensity. Unlike other respondents in

and form shareholder coalitions. If they choose to use it, British quasi-public funds should have significant influence. The Postel plan, for example, is larger in relative terms than any U.S. public fund. See Melcher & Oster (1993), *supra* note 41, at 75.

⁴³ For 1957 and 1972 data, see BRISTON & DOBBINS (1978), *supra* note 18, at 139 exh. 13, 144 exh. 20. For 1990-1991 data, see Kester (1992), *supra* note 7, at 90. We are not sure why the recent *Share Register Survey*, reported in Table 1, reports mutual fund ownership of only 6%, and suspect that some mutual fund assets are hidden within other categories in Table 1.

⁴⁴ See Mark J. Roe, *The Modern Corporation and Private Pensions*, 41 UCLA L. REV. 75, 76 n.1 (1993) (reporting Federal Reserve data).

⁴⁵ Open- and closed-end investment trusts held 3.7% of Japanese equities in 1989. JAPAN SECURITIES RESEARCH INST. (1992), *supra* note 18, at 10. This is far less than Japanese banks and insurers. Germany has no significant mutual fund industry, apart from the trust business conducted by the German universal banks.

⁴⁶ See M&G GROUP PLC, 1992 ANNUAL REPORT AND ACCOUNTS 3 (1992) [[hereinafter M&G 1992 ANNUAL REPORT]].

⁴⁷ *Id.*

our interviews, M&G told us that it seldom joins a coalition with other investors. It limits itself to one-to-one discussions. This may partly reflect M&G's tendency to invest in smaller companies, in which M&G typically is a very influential shareholder. Thus, M&G may not need to find other institutional allies.

British mutual funds trade less actively than their American counterparts but far more actively than other British institutions. In 1986, mutual fund turnover averaged about 40%, compared to less than 20% for insurers and pension funds.⁴⁸ Mutual fund managers also report that they compete intensely over relative performance records. The instinct of many mutual fund managers is to sell their shares in a troubled firm, rather than try to turn it around. Still, as in the United States, passivity is relative, not absolute, even for trading-oriented funds. Mutual fund managers, like pension fund managers, occasionally press for corporate change in a clear case.⁴⁹

4. Commercial Banks

British commercial banks are like American commercial banks, and unlike German and Japanese banks, in that they hold little stock directly.

As Table 1 shows, banks hold only 0.2% of British equities. This compares with 0.3% ownership of American equities by American banks in 1990-1991.⁵⁰

Current regulation cannot explain the passivity of British banks. From World War II until the late 1970s, the Bank of England did not count equity holdings as part of the bank's required regulatory capital. But this policy was substantially relaxed in the late 1970s. Yet the banks seem uninterested in holding equity — for which we offer a multicausal explanation in Part V.

American banks, though they hold little stock directly, are major holders as trustees for wealthy individuals. Bank trusts held 7.3% of all

⁴⁸ See CBI TASK FORCE REPORT (1987), *supra* note 16, at 22.

⁴⁹ For U.S. examples, see Alison L. Cowan, *Investors' Power Test at Borden*, N.Y. TIMES, Dec. 13, 1993, at D1; Kevin G. Salwen & Joann S. Lublin, *Activist Holders: Giant Investors Flex Their Muscles More at U.S. Corporations*, WALL ST. J., Apr. 27, 1992, at A1, A6 (describing efforts by John Neff of Windsor Fund to convince Chrysler directors to find a new CEO to replace Lee Iacocca). For a U.K. example, see John Gapper & Norma Cohen, *A tour of investors buys time for the bank*, FIN. TIMES, Mar. 19, 1993, at 19 (A mutual fund head, having met with Barclays' CEO, explains: "I got the feeling he realises the level of dissatisfaction.").

⁵⁰ See Kester (1992), *supra* note 7, at 90.

American equities in 1992, though they are usually passive investors.⁵¹ In contrast, bank trust holdings are not even separately listed in Britain.⁵²

The failure of British banks to utilize their legal authority to hold equity is more striking because their merchant banking affiliates are among the largest pension fund managers. British commercial banks seemingly could combine their holdings as pension fund managers with direct investments in order to wield influence disproportionate to the size of their direct equity stakes. In Germany, a few large banks effectively control many firms through a combination of direct holdings, stock held as a nominee for individuals, and mutual fund holdings. In Britain, this synergy has been exploited by insurers but not by commercial banks.

5. Investment Banks

British investment banks — "merchant banks" in the British phrase — like their U.S. counterparts, hold little equity for their own account but hold substantial stock as nominees for other holders, principally individuals. British merchant banks also manage substantial mutual fund and pension assets.

British investment banks have been more active in corporate governance than their almost completely passive American counterparts. As we discuss in Part IV, some merchant banks participate in institutional coalitions and occasionally lead them. But, at the same time, British investment banks play a much less prominent role than insurers. As with commercial banks, multiple factors, explored in Part V, interact to explain the degree of interest shown by investment banks in corporate governance.

B. Self-Regulatory Organizations

The second central pillar of informal oversight, British style, is self-regulation through trade associations associated with each major type of institution, plus committees and organizations that are set up from time to time. Often these committees are joint projects between the "City" — the British term for financial institutions of all types, many of which are

⁵¹ *Financial Assets & Equity Holdings*, (1993), *supra* note 9, at 47.

⁵² Some of the gap may be filled by the 2.4% of equities held in 1975 by "financial companies other than banks, insurers, and mutual funds." See BRISTON & DOBBINS (1978), *supra* note 18, at 147 exh. 22A. Perhaps, too, some trust holdings by banks are captured under the catchall phrases "persons, executors, and trustees" or "other shareholders." See *id.* at 139 exh. 13, 141-46 exh. 16-22.

located in a small district in the City of London — and British industry. We describe below the principal trade organizations and committees.⁵³

1. *Industry Trade Organizations*

Each type of British financial institution (except commercial banks) has its own trade organization — the Association of British Insurers (ABI), the Institutional Fund Managers' Association (IFMA), the National Association of Pension Funds (NAPF), the Association of Investment Trust Companies (AITC), the Association of Unit Trust and Investment Funds (AUTIF), and the British Merchant Banking and Securities Houses Association (BMBA). The trade organizations serve the classic lobbying function that one might expect, but they also serve as a nexus for corporate governance activity.

The ABI, the NAPF, and the IFMA have each been active in recent debates over corporate governance. The ABI has long fought to preserve preemptive rights and has served as the forum for "case committees." Historically, the case committee was probably the most important low-visibility institution for negotiations between institutional shareholders and corporate managers.⁵⁴ When a public corporation neared insolvency or faced some other long-term crisis, the ABI would assist in forming a committee of the insurance companies holding the largest stakes in the firm to meet with its board and typically negotiate changes in management. Membership on the case committee was usually kept nonpublic, as was the committee's existence, because its formation would cast doubt on the corporation's solvency and could depress the stock price if publicized. The committee members understood themselves to be barred from trading the corporation's securities, perhaps because this could be viewed as insider trading. More recently, the NAPF has also formed case committees of pension funds.

The case committee has declined in importance in recent years, and most of our interviewees were skeptical about its contemporary utility. Typically, case committees were viewed as "unwieldy," having too many members to act quickly or decisively. Today, a firm's largest shareholders, when they intervene, are more likely to form a loose

⁵³ This section discusses the self-regulatory organizations that are important for corporate governance issues. In addition, various self-regulatory organizations, created by the Financial Services Act 1986, ch. 60, *reprinted in main in* 30 HALSBURY'S STATUTES OF ENGLAND AND WALES 162 (4th ed. reissue 1991 & Supp. 1994) [hereinafter HALSBURY'S STAT.], regulate financial institutions but have not yet played a significant corporate governance role. *See* section III.B.

⁵⁴ *See* Davies (1994), *supra* note 8, at 273-74.

coalition on their own than to set up a case committee through the ABI or the NAPF. Also, some institutions might not want to join a case committee as this would restrict their ability to sell. Finally, a committee of only insurance companies or pension funds cannot speak for all institutional investors, yet a pan-institutional committee would be even more unwieldy. Nonetheless, our interviewees estimated that roughly two to four case committees are still formed each year.

The NAPF and the IFMA have concentrated much of their attention on encouraging shareholder voting. The IFMA, now chaired by Paddy Linaker, the chief executive of M&G, recently urged that institutions always vote shares held in a fiduciary capacity.⁵⁵ The NAPF has also developed model proxy forms that clearly authorize the fund manager to vote the pension fund's shares. At present, whether the pension trustees have delegated voting power to the fund manager is often unclear, even to the parties involved. In addition, the NAPF has established a proxy voting service to provide information on specific contests, without recommendations, to its members.⁵⁶ Both the NAPF and the ABI have also prepared guidelines regarding executive pay, the length of directors' contracts, and other corporate governance issues. Beyond forming case committees, neither the ABI nor the NAPF becomes involved in disputes at specific companies. Their activity level also depends on the identity of their frequently rotating chairmen.

2. The Institutional Shareholders' Committee

In addition to these individual trade organizations, an umbrella organization, the Institutional Shareholders' Committee (ISC), represents all major financial institutions except commercial banks.⁵⁷ The ISC was originally formed in 1973 at the behest of the Bank of England.⁵⁸ It became moribund by the late 1970s, but was revived in the 1980s. In theory, the ISC can wield more power than any one shareholder or trade

⁵⁵ The IFMA recommended that its members vote their shares at a time when only 20% of pension fund shares were voted at annual meetings. See *British corporate governance: Punters' progress*, *ECONOMIST*, Sept. 7, 1991, at 86 [[hereinafter *Punters' progress*]].

⁵⁶ See Norma Cohen, *Survey of Pension Fund Investment*, *FIN. TIMES*, May 7, 1992, at 8, available in LEXIS, News Library, Fintme File.

⁵⁷ The ISC's members are the ABI, the AITC, the BMBA, the NAPF, and the AUTIF.

⁵⁸ See RICHARD DOBBINS & THOMAS W. MCRAE, *INSTITUTIONAL SHAREHOLDERS AND CORPORATE MANAGEMENT* 5-6 (1975).

group. In practice, "the individual cases in which it intervened in regard to the composition of the board have been few and far between."⁵⁹

When the ISC was revived in the late 1980s, its then-chairman, Donald Brydon of Barclays, developed an ambitious agenda. Although we were unable to interview Brydon, many of our interviewees commented on his bold plans for the ISC — and what happened to those plans. Uniformly described as highly successful and ambitious, Brydon wanted the ISC to coordinate institutional investor intervention in corporate governance disputes. He succeeded in moving the responsibility for forming case committees away from ABI and NAPF to the ISC so that one unified committee could represent all institutions. According to some, he envisioned an enhanced case committee system under which the ISC might, for example, retain investment bankers to develop alternative business plans, maintain lists of acceptable non-executive directors whom they would seek to elect when necessary, or in a crisis obtain proxy authority from institutional investors. These changes would replace a loose-knit coalition of institutional investors with a single entity able to negotiate with management on a one-to-one basis.

These changes did not come to pass. Brydon, it seems, was too far ahead of his constituents. In 1990, the ISC chairmanship passed from Brydon to Michael Sandland of Norwich Union, a leading insurer. As it did, the ISC's goals shifted from company-specific intervention to formulating general policy positions.⁶⁰ One problem was the expense of upgrading the ISC so that it could play an activist role. No one was eager to pick up these costs. One insider told us that pension funds were reluctant to give proxies to anyone other than their fund managers. Others cited institutional rivalries within the ISC, with insurance companies being reluctant to delegate power to Brydon, who was from a merchant banking background. Responsibility for forming case committees has shifted back to the ABI and the NAPF. The ISC's self-description currently states that it "seeks to identify areas of common ground amongst its members and thereafter to promulgate those jointly held views. It does not normally become involved in matters concerned with particular investments or companies."⁶¹

⁵⁹ See Jonathan Charkham, *Are shares just commodities?*, in *CREATIVE TENSION?* (1990), *supra* note 11, at 34, 41.

⁶⁰ See Clare Dobie, *Inside the City: Bridge between City and industry still unfinished*, *INDEPENDENT*, Mar. 4, 1991, at 23.

⁶¹ See COMMITTEE ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE (CADBURY COMMITTEE), *REPORT OF THE COMMITTEE ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE* 64 (Dec. 1, 1992) [hereinafter *CADBURY COMMITTEE REPORT*].

The brief flowering and decline of the ISC as an activist body suggests limited institutional capacity to undertake collective action. There is a parallel between the ISC's limited role and the role played in the United States by the Council of Institutional Investors, which was recently described by its executive director as "a yappy dog nipping at [management's] ankles."⁶² The broader the umbrella group, the harder it is to achieve consensus, and the longer it takes to do so. This tends to limit such groups to addressing structural matters, such as board independence, that cut across many firms and are not time sensitive.

The ISC's unwillingness to take company-specific actions does not mean that the ISC is unimportant. Its published statements (*The Role and Duties of Directors — A Statement of Best Practice and The Responsibilities of Institutional Shareholders in the UK*⁶³) both express and reinforce the consensus among British institutional investors that "[m]any institutions already have effective channels of communication with the Boards of companies in which they invest" and that a "direct relationship which enables directors and shareholders to obtain a deeper understanding of each other's aims and requirements" is desirable.⁶⁴ At the same time, the institutions will normally support management. The ISC explains: "[I]nstitutional shareholders [[should] support Boards by a positive use of their voting rights *unless they have good reasons for doing otherwise*."⁶⁵ Before casting an antimanager vote, the institution should first discuss the matter with management and seek an informal solution.⁶⁶

3. Corporate Governance Reform and Boards of Directors

U.K. corporate boards are undergoing significant change. During the early 1980s, only around 33% of the directors of British public corporations were outside, or "non-executive." By 1989, this percentage had climbed to 44%, and to 50% for corporations with sales over £500

⁶² See *Council Seeks to Expand Membership Base*, INVESTOR RESP. RES. CTR., CORP. GOVERNANCE BULL., Jan.-Feb. 1993, at 15, 15.

⁶³ INSTITUTIONAL SHAREHOLDERS' COMMITTEE, THE ROLE AND DUTIES OF DIRECTORS — A STATEMENT OF BEST PRACTICE (1991) [hereinafter ISC, ROLE AND DUTIES OF DIRECTORS]; INSTITUTIONAL SHAREHOLDERS' COMMITTEE, THE RESPONSIBILITIES OF INSTITUTIONAL SHAREHOLDERS IN THE UK (1991) [hereinafter ISC, RESPONSIBILITIES OF INSTITUTIONAL SHAREHOLDERS].

⁶⁴ ISC, RESPONSIBILITIES OF INSTITUTIONAL SHAREHOLDERS (1991), *supra* note 63, at 1.

⁶⁵ *Id.* at 2 (emphasis added).

⁶⁶ *Id.*

million.⁶⁷ Similarly, in 1980, only 13% of U.K. public companies had audit committees; in 1990, this had risen to 45%. The percentage of public companies with a remuneration committee rose from 36% in 1980 to 62% in 1990.⁶⁸ Between 1991 and 1993, the percentage of the largest 100 British companies that had split the roles of chairman and chief executive officer rose from 63% to 73%.⁶⁹

The Cadbury Committee, named after its chairman, Sir Adrian Cadbury, reflects the recent U.K. ferment over corporate governance. The Cadbury Committee was formed in 1991 in the wake of the Polly Peck scandal, in which Polly Peck, a major British firm, went bankrupt after years of falsifying its financial reports. The Committee's role, initially limited to preventing financial fraud, soon expanded to cover corporate governance more generally in the wake of the BCCI and Maxwell scandals. The Committee's 1992 report covers both financial auditing and corporate governance and elicited controversy for its corporate governance recommendations.⁷⁰ Nonetheless, many of the Committee's recommendations are likely to be implemented in light of the support for the Committee's efforts from key institutions, including the Bank of England, the Confederation of British Industry, and the London Stock Exchange.

The principal Cadbury recommendations are: (i) the positions of chairman and CEO should be separated, with the board chairman monitoring the performance of management; (ii) firms should have at least three nonexecutive directors, at least two of whom should have no financial or other ties with management; and (iii) each board should have an audit committee composed entirely of non-executive directors, with a majority of *independent* non-executive directors.⁷¹ These recommendations reflect common practice; the Committee wanted them to become universal. The London Stock Exchange is expected to adopt

⁶⁷ See Simon Holberton, *Corporate governance: why the ideal board remains so elusive*, FIN. TIMES, July 4, 1990, at 10.

⁶⁸ *Id.*

⁶⁹ See Norma Cohen, *Of hats and heads*, FIN. TIMES, Feb. 5, 1993, at 10. For recent anecdotes, see *id.* (reporting that the two positions will be separated at BAT Industries); Norma Cohen, *Marshall 'might quit' if curbed*, FIN. TIMES, Jan. 23, 1993, at 5 (reporting institutional pressure on the chairman and CEO of British Airways to give up one title; he threatened to quit instead); John Gapper & Norma Cohen, *Barclays to look worldwide for chief executive*, FIN. TIMES, Mar. 25, 1993, at 1 (reporting that Andrew Buxton, chairman and CEO of Barclays Bank, gave up the CEO position "after sustained pressure from institutional investors for the roles to be split").

⁷⁰ CADBURY COMMITTEE REPORT (1992), *supra* note 61; see Norma Cohen, *Cadbury proposals prove unpalatable*, FIN. TIMES, Aug. 3, 1992, at 5.

⁷¹ CADBURY COMMITTEE REPORT (1992), *supra* note 61, ¶¶ 4.9, 4.11, 4.35.

rules requiring listed firms to disclose annually to shareholders whether they are in compliance with these and other elements of the Committee's *Code of Best Practice*.⁷²

The Cadbury Committee is representative of the British approach to corporate governance and regulation of financial institutions. U.S. lawmakers might respond to a crisis by passing a new law or regulation. The British respond with a blue-ribbon committee that recommends changes in current practice. These recommendations are usually mild, by the nature of the committee process. Indeed, the Cadbury recommendations on nonexecutive directors and audit committees lag behind common practice in the United States by around a decade. In the United States, such recommendations would often be ignored. But if a high-level British committee recommends legal change, some legal change is likely; if it recommends change in private practice, some change will predictably occur.

4. *PRO NED*

The Committee for the Promotion of Non-Executive Directors (PRO NED) was established in 1982 by "the Bank of England and other major [financial] institutions"⁷³ to encourage companies to hire more independent directors and to serve as a clearinghouse for director candidates. PRO NED's aims, however, are modest. For example, it recommends mildly that "independent Non-Executive Directors . . . should comprise about one-third of the Board" for large public companies.⁷⁴ More recently, PRO NED joined the Cadbury Committee's recommendation that public companies should have audit committees composed exclusively of nonexecutive directors.⁷⁵

PRO NED's efforts may have contributed to the trend toward British firms' having a higher proportion of independent directors. Its

⁷² *Id.* ¶ 3.7. The sponsors of the Cadbury Committee expect to convene a new committee in 1995 to review the extent of voluntary compliance and to decide whether compliance with some recommendations should be made mandatory, perhaps by including them in Stock Exchange listing standards. *Id.* ¶ 3.12.

⁷³ Brochure of PRO NED (Promotion of Non-Executive Directors), London, England (n.d., approx. 1992).

⁷⁴ PRO NED, *Code of Recommended Practice on Non-Executive Directors*, reprinted in 27 BANK ENG. Q. BULL. 252 (1987).

⁷⁵ See Norma Cohen, *Auditing role urged for non-executive directors*, FIN. TIMES, Mar. 22, 1993, at 6.

candidate list, however, has been little used.⁷⁶ Interviews with institutional investors elicited a common explanation. PRO NED directors were described to us as "good and gray," as "retired types," or as "not the entrepreneurial people needed on a board." The persons making these observations believed in the importance of outside directors, but not in PRO NED's ability to attract the needed personnel.

III. FORMAL AND INFORMAL REGULATION OF INSTITUTIONAL BEHAVIOR

A. *British Company Law*

Corporate law provides a base for institutional exercise of power, by specifying corporate actions that require shareholder consent. British company law is generally similar to U.S. corporate law on voting rules and matters put to shareholder vote.⁷⁷ Most of the constraints on British managers are found outside the company law. For example, the company law allows dual class voting structures, but the institutions oppose them with sufficient vigor that new issuances of nonvoting stock are nonexistent.⁷⁸ Poison pills are also not forbidden by company law, yet remain rare because of institutional disapproval.

Disclosure requirements were modestly strengthened in response to the takeover wave of the 1980s. A 1989 amendment to the Companies Act reduced the threshold for disclosure of major shareholdings to 3% from 5%.⁷⁹ But the filing requirement is much less onerous than the comparable Schedule 13D filing for active 5% shareholders in the United States. Each shareholder generally files only for itself. Only a formal agreement triggers an obligation for a shareholder group to

⁷⁶ See Norma Cohen, *Passing the hat round*, FIN. TIMES, Sept. 16, 1992, at 14 (reporting that PRO NED receives about 100 requests for names of director candidates each year, but only "a handful" are selected).

⁷⁷ See, e.g., Companies Act 1985 §370, reprinted in 8 HALSBURY'S STAT. (1991), *supra* note 53, at 443 - 44 (ordinary resolutions require approval by majority of votes cast, with minimal quorum requirement); Companies Act 1985 § 378, reprinted as amended in 8 Halsbury's Stat. (1991), *supra* note 53, at 449 - 50 (extraordinary and special resolutions require approval by 75% of votes cast).

⁷⁸ See, e.g., LAURENCE RABINOWITZ, WEINBERG & BLANK ON TAKE-OVERS & MERGERS § 3 - 805 (5th ed. 1989 & Supp. 1993) [hereinafter Weinberg & Blank] ("A number of proposals by companies to [issue] non-voting ordinary shares have been dropped following institutional objections, and there are no instances in recent years of a company seeking a listing [on the London Stock Exchange] for any new class of non-voting equity capital.").

⁷⁹ Companies Act 1989, ch. 40, § 134(2), PUB. GEN. ACTS 1989, at 2011, 2202 (codified at 8 HALSBURY'S STAT. (1991), *supra* note 53, at 288) (amending Companies Act 1985 § 199(2)).

aggregate its holdings;⁸⁰ there is no analogue to the American concept of an informal "arrangement" or "understanding" to acquire shares as a "group."⁸¹ Critically, the disclosure does not include a statement of the filer's plans with respect to the company, and the risk that anyone will sue claiming incomplete disclosure is remote.

The same political influences that led to the U.S. disclosure rules are also present in Britain. Corporate managers pressed for more extensive disclosure and for a freeze on new purchases for a time after a filing is made; the compromise was a required filing at a lower ownership level.⁸² Perhaps the political strength of U.K. financial institutions shaped this compromise: If institutions are weak, as in the United States, strong disclosure laws that deter the activity being disclosed are more likely to be adopted. If institutions are strong, as in Britain, the resulting disclosure rules do not constrain institutional action as sharply.

In Britain, as in the United States, fear of insider-trading liability, or of losing liquidity because one possesses inside information, is a significant obstacle to close communication between corporate managers and their major shareholders.⁸³ The ISC explains: "Institutions do not wish to be made insiders It is important that such confidences are not disclosed to investors by companies . . . without the investors' prior consent."⁸⁴

B. Securities Industry Regulation

The regulation of financial institutions, long largely informal, took a major step toward stronger formal regulation with the adoption of the Financial Services Act 1986, which gave the Treasury Department

⁸⁰ Companies Act 1985 § 204, *reprinted in* 8 HALSBURY'S STAT. (1991), *supra* note 53, at 292-93.

⁸¹ Securities Exchange Act of 1934 Rule 13d-3(a), 17 C.F.R. § 240.13d-3(a) (1993).

⁸² For a British CEO's proposal to strengthen the disclosure rules in this manner, see Sir Hector Laing, *The Balance of Responsibilities*, in *CREATIVE TENSION?* (1990), *supra* note 11, at 59, 67-69.

⁸³ Liability for insider trading in the United Kingdom is now governed by Part V of the recently passed criminal Justice Act 1993. See 30 HALSBURY'S STATUTES: CURRENT STATUTES SERVICE, Money tit., at 9 (4th ed. 1994) [[hereinafter HALSBURY'S CURRENT STAT.]. For a discussion of the new act, see Keith Wotherspoon, *Insider Dealing — The New Law: Part V of Criminal Justice Act 1993*, 57 MOD. L. REV. 419 (1994).

⁸⁴ ISC, RESPONSIBILITIES OF INSTITUTIONAL SHAREHOLDERS (1991), *supra* note 63, at 2 (emphasis added). In Britain, a shareholder who obtains confidential "price sensitive information" from an insider may not trade on that information, even if the recipient has not agreed to keep the information confidential. Criminal Justice Act 1993 §§ 52-53, 56, *reprinted in* 30 HALSBURY'S CURRENT STAT. (1994), *supra* note 83, Money tit., at 11-13, 15.

overall responsibility for financial services regulation.⁸⁵ Still, the City was largely able to interpose one and sometimes two layers of self-regulatory bodies between itself and the Treasury Department. An umbrella self-regulator — the Securities Investment Board — oversees industry-specific self-regulatory bodies, including the London Stock Exchange, Imro (the Investment Management Regulatory Organization), Lauto (the Life, Annuity, and Unit Trust Regulatory Organization), and Fimbra (which governs independent financial advisers).⁸⁶ The future of self-regulation, though, is hard to predict. Its political legitimacy was weakened by the Maxwell scandal, and some major institutions, including Prudential and National Westminster Bank, have called for direct government oversight.⁸⁷

C. Takeover Panel Rules

The American debate over the pros and cons of takeovers, and the supposedly short-term orientation of large shareholders, was replayed in Britain, which experienced its own takeover wave in the 1980s.⁸⁸ The outcome of the debate, however, was very different. American corporate managers largely lost the academic debate on the merits of takeovers but won the war in the legislative trenches. Their already broad power to resist takeovers was broadened as state legislatures enacted tough antitakeover statutes and state courts and legislatures endorsed poison pill defenses.⁸⁹ In Britain, defensive powers were limited to begin with and changed little over the decade. There simply are no poison pills, targeted share placements, or lock-up options by which target managers can block a tender offer. The restrictive British approach to takeover defenses may reflect, in part, the political power of British institutions. It may also reflect managers' lesser power in a legal system where the managers lack a choice among competing jurisdictions, each eager for

⁸⁵ Financial Services Act 1986, ch. 60, reprinted in 30 HALSBURY'S STAT. (1991), *supra* note 53, at 162.

⁸⁶ See generally JAMES J. FISHMAN, THE TRANSFORMATION OF THREADNEEDLE STREET 75-108 (1993).

⁸⁷ See Norma Cohen & Peter Martin, *Back to the drawing-board: Financial self-regulation in the UK is facing mounting calls for reform*, FIN. TIMES, Nov. 26, 1992, at 20.

⁸⁸ For pieces of the debate, see, for example, CBI TASK FORCE REPORT (1987), *supra* note 16; CREATIVE TENSION? (1990), *supra* note 11 (collection of essays by corporate and financial institution executives); PAUL MARSH, SHORT-TERMISM ON TRIAL (1990) (study commissioned by the IFMA).

⁸⁹ See generally Mark J. Roe, *Takeover Politics*, in THE DEAL DECADE: WHAT TAKEOVERS AND LEVERAGED BUYOUTS MEAN FOR CORPORATE GOVERNANCE 321 (Margaret M. Blair ed., 1993); Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111 (1987).

them to incorporate.

In Britain, the dominant source of rules governing takeovers, control contests, and acquisitions of large blocks of shares is the *City Code on Take-overs and Mergers* and the related *Rules Governing Substantial Acquisitions of Shares*, issued and periodically revised by a nongovernmental body — the Panel on Take-overs and Mergers. The City Code prohibits essentially all defensive actions when a takeover bid is pending or when the target has "reason to believe that a bona fide offer might be imminent."⁹⁰ The Takeover Panel often issues interpretations or new rules in midcontest to handle unanticipated situations. The Bank of England chooses the chair of the Takeover Panel; its members include representatives of institutional investors, public companies, and the London Stock Exchange.⁹¹ The Takeover Panel has no formal regulatory power, but its rules are universally obeyed.⁹²

The City Code basically bans defensive tactics during the pendency of a offer, as well as preclusive pre-bid actions, such as adopting a poison pill. Once a bid is made, any defensive action requires shareholder approval — which will be forthcoming only when the shareholders would have rejected the bid anyway. At the same time, partial and two-tier bids are forbidden. Anyone who crosses the 30% ownership level must offer to buy all remaining shares at a uniform price.⁹³

The effect is that the shareholders decide whether a takeover bid succeeds or fails. When a firm's major shareholders are happy with management's performance, they will often collectively turn down a takeover bid, despite the short-term profit available from selling their shares.⁹⁴ When the major shareholders are unhappy with management,

⁹⁰ PANEL ON TAKE-OVERS & MERGERS, THE CITY CODE ON TAKE-OVERS AND MERGERS RULE 21 (1993) (listing prohibited actions); *see also id.* General Princ. 7 (stating that the target shall not take any action without shareholder approval "which could effectively result in any bona fide offer being frustrated").

⁹¹ *See id.* at A2 (listing the Panel's membership).

⁹² The sanctions for noncompliance with the City Code include delisting by the London Stock Exchange, the refusal of banks and stockbrokers, who have all agreed to abide by the Code, to trade the company's shares, and the likely revolt of institutional shareholders at the next general meeting.

⁹³ *See* PANEL ON TAKE-OVERS & MERGERS (1993), *supra* note 90, Rule 9.1. For an overview of British takeover regulation, see Deborah A. DeMott, *Comparative Dimensions of Takeover Regulation*, 65 WASH. U. L.Q. 69, 93-99 (1987).

⁹⁴ *See* TRADE & INDUSTRY COMMITTEE, HOUSE OF COMMONS, TAKEOVERS AND MERGERS: MINUTES OF EVIDENCE, 1990-1991 Sess. 278 (1991) [hereinafter TAKEOVERS AND MERGERS] (testimony of Michael Sandland of Norwich Union); Artus (1990) *supra* note 11 at 13.

they will be delighted to sell their shares at a premium to market, and there is little that the managers can do to stop them.

D. Stock Exchange Rules and Preemption Guidelines

A further source of nongovernmental regulation is the London Stock Exchange's listing rules and guidelines for listed companies. The rules are binding on all listed companies. These include obligations to comply with the City Code, to follow prescribed procedures for proxy voting at shareholder meetings, and to seek shareholder approval to disapply preemptive rights (which is needed under company law) only for the interval between annual shareholder meetings.⁹⁵

In addition, the London Stock Exchange publishes various guidelines, of which the most important are the Pre-emption Guidelines. The *Pre-emption Guidelines* were developed in the late 1980s by a joint industry-City-London Stock Exchange group called the Pre-emption Group and are discussed below.⁹⁶ The guidelines are only advisory but have the same practical effect as formal rules for large companies, who would face a shareholder revolt if they did not follow the guidelines.

IV. INSTITUTIONAL MONITORING IN THE UNITED KINGDOM: WHAT DOES AND DOES NOT HAPPEN

The extent of collective action undertaken by British institutional investors has long remained hidden, in large part because the institutions usually act quietly and behind the scenes. Limited knowledge is available from a variety of sources, including (i) prior academic research, (ii) publicly reported instances in which institutions have challenged managements, (iii) public statements by financial institution executives, and (iv) the available data on shareholder voting. Each of these is a useful but imperfect source of information. For example, the public statements of officials can be self-serving (and tend to be maddeningly vague), and the failure of institutional investors to vote on routine matters is not proof of passivity. Finally, the paucity of incidents in which institutions publicly unite to oust corporate managers may demonstrate only the truism that the parties to any dispute tend to

⁹⁵ WEINBERG & BLANK (1993), *supra* note 78, at 8001 (reprinting LONDON STOCK EXCHANGE, ADMISSIONS OF SECURITIES TO LISTING (1991)).

⁹⁶ *See infra* section IV.C.2.

"bargain in the shadow of the law" and seldom proceed to the end game stage of a public dispute resolved by shareholder vote.

Given these problems, in-depth interviews with institutional investors seemed a largely missing and important source of evidence. During the summer of 1992, one of us (Coffee) visited London and conducted prearranged interviews with senior executives at a representative sample of leading insurance companies, mutual funds, pension money managers and self-regulatory organizations. These interviews focused on the extent to which British institutions engage in low-visibility forms of collective action and on their willingness to take high-visibility actions when behind-the-scenes efforts are unavailing. These interviews inform our discussion in this Part of what British institutions do and do not do in the corporate governance realm.

We begin with a review of prior research in section IV.A and an overview of what British institutional investors say in public about their corporate governance role in section IV.B. We then turn in sections IV.C to IV.E to what the institutions actually do.

A. Prior Research

The Berle-Means thesis that shareholder dispersion implies weak oversight over management has long received a skeptical reception among British academics. Writing in 1961, Professor Florence argued that Berle and Means had overstated managerial power by focusing only on the largest two or three shareholders, thereby ignoring the potential for collective action among a small group of shareholders, none of whom alone held a decisive stake.⁹⁷ Florence believed that research should focus on the twenty largest shareholders, who, he argued, often held enough shares to effectively control even the largest British corporations.⁹⁸ In 1936, the median proportion of voting shares held by the twenty largest shareholders in the eighty-two largest nonfinancial British firms was about 40% — compared to 28% for a similar sample of 132 American corporations.⁹⁹ Moreover, in 40% of the British companies, the twenty largest shareholders held an absolute majority of the voting stock, while a similar concentration existed in only 24% of

⁹⁷ P. SARGANT FLORENCE, *THE LOGIC OF BRITISH AND AMERICAN INDUSTRY* 192 n.2 (rev. ed. 1961).

⁹⁸ *Id.* at 187.

⁹⁹ *Id.* at 189.

American companies surveyed.¹⁰⁰ The table below summarizes Florence's data:

TABLE 3
SHARES IN LARGE U.K. FIRMS
HELD BY TWENTY LARGEST SHAREHOLDERS IN 1936

<i>Percentage Held</i>	<i>Number of Firms</i>	<i>%</i>
0-9.9%	7	9
10-19.9%	11	13
20-39.9%	17	21
30-49.9%	14	17
50% and up	33	40
TOTALS	82	100

In 1986, John Scott, a sociologist, reexamined Florence's hypothesis that a loose-knit coalition of twenty or so shareholders could potentially control most large British corporations.¹⁰¹ Scott's data, from a sample of 100 of the 250 largest financial and nonfinancial companies in 1977, showed that ownership concentration had fallen, as shown in the following table. The top twenty institutions never held majority control, but they typically held an influential 20% -29% of the voting stock — a level of ownership that could carry control of a U.S. public corporation if held by a single shareholder.¹⁰²

TABLE 4
BRITISH OWNERSHIP CONCENTRATION IN 1977

<i>Percentage of Shares Held by Top 20% Shareholders</i>	<i>Number of Enterprises</i>		<i>Total</i>
	<i>With Family Participation</i>	<i>Without Family Participation</i>	
More than 50%	0	0	0
40-49%	1	3	4
30-39%	3	10	13
20-29%	26	35	61
10-19%	6	16	22
Less than 10%	0	0	0
TOTALS	36	64	100

One can gain a fuller sense of the potential for collective shareholder action in the mid-1970s by examining Scott's list of the twenty largest shareholders of Imperial Group, one of Britain's largest industrial companies at the time. We reproduce that list below

¹⁰⁰ *Id.*

¹⁰¹ See JOHN SCOTT, CAPITALIST PROPERTY AND FINANCIAL POWER: A COMPARATIVE STUDY OF BRITAIN, THE UNITED STATES AND JAPAN (1986); see also John Scott, *Corporate control and corporate rule: Britain in an international perspective*, 41 BRIT. J. SOC. 351 (1990).

¹⁰² SCOTT (1986), *supra* note 101, at 95.

alongside, for comparison, a list of the twenty largest institutional holders of Procter & Gamble in 1990 (P&G is representative of ownership concentration in the largest American firms).¹⁰³

TABLE 5

IMPERIAL GROUP—1977		PROCTER & GAMBLE—1990	
<i>Shareholder</i>	<i>Holding %</i>	<i>Shareholder</i>	<i>Holding %</i>
Prudential Assurance	2.4	PNC Financial	1.7
Legal & General Assurance	1.8	CalPERS	1.4
Hill Samuel	1.4	Wells Fargo	1.0
National Westminster Bank	1.4	Bankers Trust	1.0
National Coal Board	1.4	Mellon Bank	1.0
M&G Group	1.0	Rosenberg Equity Mgmt.	0.9
Barclays Bank	0.9	MNC Financial	0.9
Brittanic Assurance	0.9	N.Y. State Pension Fund	0.9
Royal Assurance	0.8	Star Bank, Cincinnati	0.7
Kuwait Investment Office	0.7	N.Y. State Teacher's Pension	0.6
Save & Prosper Group	0.7	CREF	0.6
Cooperative Group	0.6	State Street Boston Corp.	0.5
Commercial Union	0.6	Texas Teachers Pension	0.5
Norwich Union	0.5	Investors Research	0.5
Wills family	0.5	State Street Research	0.4
Mercury Securities	0.5	Sunbank Capital Mgmt.	0.4
Pearl Assurance	0.4	Dodge & Cox	0.4
Midland Bank	0.4	Cal. Teachers Pension	0.4
General Electric	0.4	Miller, Anderson & Sherrerd	0.3
Sun Life Assurance Company	0.4	TCW Management	0.3
TOTAL	17.7%	TOTAL	14.1%

For our purposes, Scott's data has several uses. First, it provides a benchmark. There has been a sharp increase in concentration in Britain compared to the level he describes as of the mid-1970s. Today, by one estimate, the twenty-five largest shareholders own an absolute majority of the shares of many publicly held British corporations.¹⁰⁴ Second, Scott's data shows that, although much has changed, the players are the same. Scott found that the same institutions regularly appeared in his lists. His roster of large shareholders in 1977, ranked by the number of times they appeared in what he called "controlling constellations" (the

¹⁰³ *Id.* at 94. For Procter & Gamble data, see Carolyn K. Brancato, Institutional Investor Concentration of Economic Power: A Study of Institutional Holdings and Voting Authority in U.S. Publicly Held Corporations, Part I: Top 25 U.S. Corporations as of December 31, 1990 app. 2 (Sept. 12, 1991) (unpublished manuscript, Columbia Institutional Investor Project, Columbia Univ. School of Law Ctr. for Law & Economic Studies) (this data is for shares held with *sole voting power*; the total holdings by P&G's top 20 shareholders were 18.8%).

¹⁰⁴ See Jackson (1991), *supra* note 10.

top twenty shareholders of each company) reads like a roster of Britain's largest institutional investors today:¹⁰⁵

TABLE 6
LARGEST BRITISH INSTITUTIONAL INVESTORS—1977

<i>Institutional Investor</i>	<i>Number of Appearances Among Top 20 Shareholds (for 100 firms)</i>
Prudential Assurance	88
National Coal Board	75
Cooperative Group	64
Legal & General Assurance	64
Norwich Union Insurance	64
Pearl Assurance	60
Barclays Bank	55
Hill Samuel	52
Robert Fleming	52
Electricity Council	48
Mercury Securities	48
Royal Insurance	46
“Shell” Transport and Trading Pension	45
National Westminster Bank	44
Commercial Union Assurance	42
Britannic Assurance	39
Midland Bank	39
Church Commissioners	38
General Accident	38
Save & Prosper Group	37

Although we lack data for the 1950s and 1960s, when institutions were replacing individuals as the largest shareholders, the Florence and Scott studies suggest that ownership and control were never as separated in the United Kingdom as in the United States. British corporate managers thus may have never had the same sustained opportunity to become entrenched. Concentration levels dipped temporarily as institutions replaced individual shareholders, but this was only a modest deviation from a long-run pattern of concentrated ownership.

The similarity of British concentration in 1977 to U.S. concentration today suggests that the British experience may foreshadow the future course of institutional activism in U.S. corporate governance. There remain, however, important differences. In the United States, both legal constraints and the smaller size of U.S. institutions relative to the U.S. equity market make it likely that we will see only a gradual increase in the stakes held by

¹⁰⁵ SCOTT (1986), *supra* note 101, at 100.

the largest shareholders, rather than a quick shift to current levels of British ownership concentration.¹⁰⁶

B. *Money Manager Statements*

A second source of background information about British institutions is the public statements of British money managers. The general themes that emerge from these statements — themes that are broadly consistent with our interview evidence — are frequent dialogue, occasional informal intervention when a firm is in trouble, but only infrequent formal intervention. Both commentators and fund managers agree that institutions should operate behind the scenes whenever possible. The Institutional Shareholders' Committee explains: "The most effective action is taken quickly, and without publicity."¹⁰⁷

As to how active the institutions are, R.E. Artus, chief investment manager of Prudential Corporation, one of the more active institutional investors, recently wrote:

In any given week our senior investment managers and specialist support staff will have contact with a dozen or more companies and their professional advisers, concerned with the relationship between companies and their shareholders, and quite distinct from the programme of meetings with our [security] analysts

. . . .
 . . . [I]ntervention by shareholders does in fact occur from time to time, and we have been concerned with some well known instances as well as many more less publicised cases. But the extent of such activity by shareholders in Britain does not remotely approach the level where it is an effective substitute for the involvement of the banks in Germany or the Keiretsu system in Japan.¹⁰⁸

Many British commentators wish that institutions would be more engaged, but few have prescriptions for how to bring this about. The British worry about whether the stock market encourages a short-term orientation on the part of corporate managers, and they envy the willingness (so they believe) of Japanese and German banks to intervene

¹⁰⁶ We consider these and other likely continuing differences between the United States and Britain in Part VI.

¹⁰⁷ ISC, RESPONSIBILITIES OF INSTITUTIONAL SHAREHOLDERS (1991), *supra* note 63, at 3; *see also* TAKEOVERS AND MERGERS (1991), *supra* note 94, at 278 (testimony of Michael Sandland of Norwich Union).

¹⁰⁸ Artus (1990), *supra* note 11, at 12, 14. Professor James Ball, Chairman of Legal & General Group PLC, states, "We are certainly not passive [W]e like to meet directly with the managers of a company, generally in a one to one meeting, and we like to focus on the strategy of the business." James Ball, *Financial Institutions and their role as shareholders*, in CREATIVE TENSION? (1990), *supra* note 11, at 18, 25; *see also* M&G 1992 ANNUAL REPORT, *supra* note 46, at 3 (containing the mission statement of M&G, *quoted* in section II.A.3).

when a firm gets in trouble. A representative statement from Jonathan Charkham, until recently the Bank of England's senior adviser on corporate governance matters:

Unlike Germany and Japan, UK company management lacks both regular sources of sympathetic influence and, in the rare cases where it is essential, the stimulation of remedial action The Companies Acts give shareholders the necessary powers to [exercise] influence, but for various reasons they seldom do so.¹⁰⁹

Yet, to American eyes, this breast beating seems overdone. British institutions turn over their portfolios much more slowly than their American counterparts. Many of the largest British institutions profess a long-term view, including willingness to turn down a takeover premium, and to try to change management rather than sell their shares. Over half of all hostile bids fail, compared to only about twenty percent in the United States in the days before poison pills. Often, the institutions band together to support the target's management, and are willing to accept "a short-term fall in the biddees share price below the bid value."¹¹⁰

C. *The Extent of Informal Shareholder Action*

The general statements quoted in section IV.B give only limited insight into how often the institutions intervene in corporate affairs, and what institutional investors actually do. Scott, for example, doubted that his "constellations" of top twenty shareholders could easily act "as a cohesive group."¹¹¹ Rather, he concluded that their power lay, first, in their ability to cause the failure of "any attempt to raise new capital through a rights issue," and, second, in their power to veto a proposed restructuring if the corporation encountered financial trouble.¹¹² This description still captures much of the influence that institutional investors have over corporate managers.

1. *Protecting Shareholder Rights*

One common goal of a shareholder coalition is to protect or restore shareholder rights for later use. A paradigmatic example is a dispute that arose in the mid-1970s between institutional investors and Lloyds Bank over a provision in Lloyds's Articles of Association that capped voting

¹⁰⁹ JONATHAN CHARKHAM, CORPORATE GOVERNANCE AND THE MARKET FOR COMPANIES: ASPECTS OF THE SHAREHOLDERS' ROLE 7 (Bank of Eng. Discussion Paper No. 44, 1989).

¹¹⁰ Artus (1990), *supra* note 11, at 13.

¹¹¹ SCOTT (1986), *supra* note 101, at 95.

¹¹² *Id.*

rights at 500 votes per shareholder.¹¹³ This provision limited Lloyds's twenty largest shareholders, who collectively held 16% of its stock, to voting power of only 0.01% each. In 1978, institutional pressure forced Lloyds to drop this provision and return to the normal one-share, one-vote allocation of voting power.¹¹⁴ Although twenty-odd shareholders, each holding only 0.01% of the voting power, obviously could not compel such a change, large shareholders were able to credibly threaten not to participate in Lloyds's subscription offerings. Similar market-based pressure appears to have worked in a number of other cases.¹¹⁵

The Lloyds case illustrates both the potential for and the limitations on collective action by institutional investors. First, the stakes were high. Not only were basic voting rights at issue, but the issue was not limited to one firm. If Lloyds could limit institutions to a maximum number of votes, other companies would predictably follow suit. In such cases, British institutions have recurrently fought. Institutional investors have regularly objected to attempts to issue nonvoting or limited voting shares. As a result, according to a leading treatise, "there are no instances in recent years of a company seeking a listing for any new class of non-voting equity capital."¹¹⁶

Not only were the stakes high in the Lloyds case, but the cost of opposition was low. The beauty of a shareholder refusal to subscribe to a preemptive rights offering as a strategy is that it costs little and forces the issuer to come to the shareholders to negotiate, not the reverse. Information costs were also low. Because issues surrounding voting are easy to understand and are not company specific, shareholder coordination costs are lower than for disputes over business strategy or the competence of specific managers. These costs are further reduced by two other factors: (i) there can be economies of scale associated with organizing with regard to recurring issues; and (ii) if shareholder opposition can be coordinated through an industry association such as the NAPF or the ABI, the free-rider problem is reduced because the association's costs will be spread among all of its members. The minimum twenty-one-day period that

¹¹³ See *id.* at 99.

¹¹⁴ *Id.*

¹¹⁵ *Id.* at 127 n.39 (citing a case involving Peninsular & Oriental); Ian H. Fazey, *Trinity Intl turns in £9.44m and enfranchises shareholders*, FIN. TIMES, Sept. 15, 1993, at 28; Paul L. Davies & Geoffrey P. Stapledon, Comment on Black & Coffee, *Hail Britannia?: Institutional Investor Behavior under Limited Regulation* 2 n.5 (July 1993) (unpublished manuscript, on file with authors) (discussing Austin Reed, Liberty, GUS).

¹¹⁶ WEINBERG & BLANK (1989), *supra* note 78, § 3 - 805.

a preemptive rights offering must remain open provides ample time for a number of large shareholders to coordinate their actions.¹¹⁷

One sees preservation of shareholder rights also in what did *not* happen to takeover rules in response to the 1980s takeover wave. British takeover defenses were much more limited than American defenses when the decade began; the gap increased as American courts and legislatures blessed poison pills and other potent defenses. British firms pushed for stricter regulation, but the institutions were able to preserve the market for corporate control as a constraint on managerial discretion.

2. *Protecting the Preemptive Rights Weapon*

Refusal to subscribe to a preemptive rights offering has a serious theoretical weakness as a source of shareholder leverage over managers. British company law allows a company to seek shareholder approval to "disapply" preemptive rights for up to five years at a time.¹¹⁸ Company law also lets companies issue rights to buy new shares at a very large discount to the pre-offer market value of their shares. A large discount forces current shareholders either to subscribe, sell their rights to someone else who will subscribe, or face severe dilution. Conversely, the smaller the discount, the more feasible the strategy of refusing either to subscribe or to sell one's rights, expecting other shareholders to act the same way. Moreover, if the discount is only a few percent, refusal to subscribe by a firm's largest shareholders can send a negative signal to other potential investors, cause the share price to drop below the subscription price, and thereby cause the rights offering to fail.

Institutional investors have been zealous in defending preemptive rights and the leverage they provide. In the mid-1980s, companies began to seek broad authority from shareholders to disapply preemptive rights for up to the maximum five-year period permitted by company law, and also sought to circumvent preemptive rights by issuing convertible debt on terms that made conversion in the near future virtually certain. Institutional shareholders revolted. The ABI and NAPF advised their members to reject disapplication requests except in very narrow circumstances.¹¹⁹

¹¹⁷ See Companies Act 1985 § 90(6), reprinted in 8 HALSBURY'S STAT. (1991), *supra* note 53, at 201.

¹¹⁸ See Companies Act 1985 §§ 80(4), 80(5), 95, reprinted in 8 HALSBURY'S STAT. (1991), *supra* note 53, at 193, 204.

¹¹⁹ For a fuller description of this controversy, see Davies & Stapledon (1993), *supra* note

In response, the London Stock Exchange limited the disapplication period to the one-year interval between shareholders' meetings. In addition, a joint industry-City-London Stock Exchange working group was formed, called the Pre-emption Group, which issued, and has since periodically revised, its *Pre-emption Guidelines*. The guidelines generally limit nonpreemptive issuances to 5% or less of a company's share capital in any one year and 7.5% or less over a rolling three-year period.¹²⁰ As a practical matter, the guidelines are binding on all public companies. Major shareholders will not vote for a disapplication proposal that exceeds the guidelines, and the major investment banks will not underwrite such an offering. The *Pre-emption Guidelines* do not limit the discount that a listed company can offer in a rights offering. However, companies know that if they attempt a coercive, deep discount offer, they are likely to face a shareholder revolt at the next annual meeting, and investment bankers know that a coercive rights offering will alienate their best customers. Thus, deep discount offers are rare.¹²¹

3. *CEO Replacement*

At the opposite end of a continuum from general to company-specific issues is replacement of a poorly performing CEO. Here, the institutions' performance is mixed. As we discuss in more detail below, in a number of recent cases, institutional pressure has prompted a change in CEO. Even before these recent episodes, there was a long history of instances in which a board replaced a CEO in order to secure a successful subscription offering. But the road to CEO replacement is long and bumpy, and many institutional efforts get sidetracked in various ways. The limits on institutional prodding are especially evident when companies do not need new equity capital and therefore are less vulnerable to institutional refusal to subscribe to a rights offering.

4. *Board Structure and Membership*

Twenty-five years ago, British and American boards looked much alike. They were numerically dominated by inside directors. The CEO also served as board chairman, selected new directors, and thoroughly dominated the boardroom. Since then, both countries have

115; *Who's Running the Show? Why UK Institutions Are Blocking Equity Issues*, BUS. INTL. MONEY REP., May 11, 1987, at 146.

¹²⁰ LONDON STOCK EXCHANGE, PRE-EMPTION GUIDELINES §§ 1.2, 2.1 (1987).

¹²¹ Conversation with Jonathan Charkham, former adviser on corporate governance, Bank of England, in New York, N.Y. (May 5, 1994).

moved toward greater board independence, though in different ways. In the United States, almost all large company boards now have a majority of *outside* directors, and an increasing number have a majority of *independent* directors — directors without business or family ties to the firm.¹²² The CEO, however, still usually chairs the board.

In Britain, a large percentage of British firms, under institutional prodding, have separated the jobs of CEO and chairman of the board, and many have assigned the role of chairman to an outside director. On the other hand, Britain has moved more slowly toward independent boards and separate audit committees.¹²³ In Britain, as in the United States, institutional investors rarely sit on corporate boards themselves.

It is not clear how much to make of these differences. Perhaps British institutions are strong enough that they feel less need for majority-independent boards, as long as there are *some* independent directors who can be contacted in case of need. Moreover, the two countries are converging, as more U.S. firms appoint separate board chairmen and British institutions become "increasingly prepared . . . where necessary to encourage Boards to appoint an adequate number of independent non-executive directors."¹²⁴ Still, the prevalence of insider-dominated boards suggests that institutional concern with board structure was less than vigorous in the past.

5. Voting Behavior

In the United States, most institutions, even if they routinely support management, at least vote their shares. In the United Kingdom, most institutions historically have not voted. For example, fewer than 20% of pension funds surveyed by the NAPF in 1991 regularly voted.¹²⁵

It is unclear how important the lack of formal voting is. Institutions do vote in proxy fights. For example, a recent proxy fight at Wart produced a 96% turnout; strong institutional support enabled the incumbents to defeat a dissident shareholder despite the dissident's 29% holding.¹²⁶ Informal access to corporate executives and nonexecutive directors may largely obviate the need for

¹²² See Black (1992), *supra* note 17, at 840-42.

¹²³ See *supra* section II.B.3.

¹²⁴ ISC, RESPONSIBILITIES OF INSTITUTIONAL SHAREHOLDERS (1991), *supra* note 63, at 3.

¹²⁵ See Norma Cohen, *Investors export US zeal*, FIN. TIMES, Feb. 12, 1993, at 12.

¹²⁶ See Norma Cohen, *Wart board changes blocked by institutions*, FIN. TIMES, Sept. 5, 1992, at 8.

American-style shareholder proposals. Some fund managers even argue that they should not vote on routine matters, as this will only lull management into believing that the institutions support them.¹²⁷ Most of those we interviewed, however, took the opposite position — that fund managers who vote regularly created a greater impression when they withheld their votes. One said that by voting routinely and then withholding as a specific protest, he ensured that management would call and request his proxy, thereby creating an opportunity to explain his dissatisfaction.

In general, fund managers agree that shares should be voted but point to logistical problems. A fund manager may serve as a fiduciary for several dozen (and sometimes a hundred or more) clients holding a particular stock. Some may have granted proxy authority to the fund manager; others may not have. Moreover, the typical agreement between a fund manager and its pension clients giving the manager the power to vote the clients' shares requires the fund manager to first consult the client on "contentious" matters. A vote against management is arguably "contentious"; moreover, many fund managers believe that it is good client relations to consult with their clients before opposing management.

Yet consulting dozens of clients is a time-consuming chore. Several fund managers reported to us that the intense competition among fund managers for pension business means that they cannot easily pass on the costs of voting to the client. These costs include not only the de minimis direct costs of voting but also the cost of research on voting issues and the indirect costs of client consultation.

In any event, a major transition seems to be in progress in fund managers' attitudes towards voting. In 1991, the IFMA recommended that its members should always vote their shares.¹²⁸ Two of the largest fund managers in Britain — Robert Fleming and Phillips & Drew — have adopted policies either to always vote or to vote whenever they hold over 1% of the issuer's shares.¹²⁹ M&G Group, the largest unit-trust manager, has decided to vote whenever it owns more than 2.5% of the company.¹³⁰ Prudential, Britain's largest institutional investor, informed us, "We vote every share." Thus,

¹²⁷ Peter Stormonth Darling, former chairman of Mercury Asset Management, took this position in a 1992 interview with the *Institutional Investor*. See Claire Makin, *Boardroom brawl*, *Institutional Investor*, June 1992, at 134, 139.

¹²⁸ See *Punters' progress* (1991), *supra* note 55, at 86.

¹²⁹ *Id.*

¹³⁰ *Id.*

institutional voting is likely in the near future to become the rule, rather than the exception.

This shift could reflect the confluence of several factors: First, as institutional stakes become larger and subject to a greater liquidity discount on sale, logic dictates that institutional shareholders should rely more on "voice" and less on "exit." Second, voluntary rules, such as the IFMA proposal, may be seen as an alternative to state intervention. Third, American influence may also have an impact. British institutions have observed the American voting practices and also realize that if they do not vote, the votes of American institutions, who own a significant fraction of British equities, could dictate the outcome of shareholder votes.

6. *Management and Director Compensation*

British institutional investors have begun to address the difficult task of establishing optimal manager and director compensation. For example, the NAPF has urged companies to award management stock options that pay off only if the company outperforms a broad index of all British equities,¹³¹ and the ISC opposes stock-option awards and retirement plans for directors.¹³² But British executive compensation is, on the whole, even less sensitive to firm performance than American compensation. Very few public U.K. companies have adopted incentive compensation arrangements, and only seven of the FTSE-100 fully meet the Cadbury Committee's recommendations on remuneration.¹³³

The complex incentives created by different pay schemes make it hard to tell whether these proposals are sound; indeed, the ABI does not endorse the NAPF proposal. Still, the outlandish compensation of CEOs at many American (and some British) firms¹³⁴ suggests that this is an appropriate area for shareholder oversight. One wonders whether the relative restraint shown by British CEOs is self-restraint

¹³¹ See Norma Cohen, *Stock option schemes queried*, FIN. TIMES, Sept. 16, 1992, at 10.

¹³² ISC, *ROLE AND DUTIES OF DIRECTORS* (1991), *supra* note 63, at 3.

¹³³ See *Directors' pay*, FIN. TIMES, July 6, 1992, at 12. The Cadbury Committee recommended: (i) that shareholders receive "a full and clear statement of directors' present and future benefits"; (ii) that future service contracts should run no longer than three years; (iii) that boards should have remuneration committees consisting "wholly or mainly of non-executive directors and chaired by a non-executive director"; and (iv) that executive directors should "play no part in decisions on their own remuneration." CADBURY COMMITTEE REPORT (1992), *supra* note 61, ¶¶ 4.40-4.42.

¹³⁴ See generally GRAEF S. CRYSTAL, *IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES* (1992).

or reflects British shareholders' greater power to object to inappropriate pay levels.

7. Diversification: The Objections Not Made

A major motive for U.S. takeovers in the 1980s was reversing prior diversification efforts, most of which had turned out badly.¹³⁵ Active shareholders could potentially discourage diversification, which may benefit undiversified or empire-building managers at the expense of already diversified shareholders.¹³⁶ Yet many large British firms diversified over the same period as their American counterparts, with similarly poor results, based on anecdotal evidence. Large shareholders largely sat on the sidelines and watched the diversification trend unfold.

The lack of organized shareholder opposition to diversification efforts is understandable. Neither of the two principal justifications for intervention applies to these cases. First, there was no principle of shareholder rights at stake; and second, there was no acute financial crisis. Absent these conditions, British institutions are generally unwilling to intervene. Imprudent diversification may become one item in a list of particulars that the institutions would raise in pushing for managerial change, but this relatively weak constraint did not stop the diversification trend. Whatever the cause, shareholder failure to object more strongly to diversification efforts suggests limits on the potency of British-style oversight. The survival of conglomeration as a respectable strategy also suggests that shareholder oversight cannot fully substitute for the market for corporate control, in which a financial entrepreneur can profit by breaking a conglomerate into several parts and selling the pieces.

D. Proxy Fights: The Exceptional Case

Given the concentrated institutional ownership of British equities, it is reasonable to presume that institutions in Britain should be able to exercise voting control, at least when the case for intervention seems clear. Nonetheless, instances in which institutions have publicly taken coordinated action to oust managers are conspicuous by their rarity.

The paucity of visible examples may reflect British preference for quiet, behind-the-scenes negotiation. Just as most lawsuits settle

¹³⁵ See, e.g., RONALD J. GILSON & BERNARD S. BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* ch. 9 (2d ed. 1994); Sanjai Bhagat, Andrei Shleifer & Robert W. Vishny, *Hostile Takeovers in the 1980s: The Return to Corporate Specialization*, in *BROOKINGS PAPERS ON ECONOMIC ACTIVITY: MICROECONOMICS 1990*, at 1 (Martin N. Baily & Clifford Winston eds.).

¹³⁶ See, e.g., Black (1992b), *supra* note 17, at 903-06.

without trial, most corporate governance disputes may be resolved privately as the parties "bargain in the shadow of the law." Yet, the process of backstage negotiation should sometimes break down and leave discernible evidence of the formation of investor coalitions. The folklore of the City provides only a few well-known stories of such interventions through the early 1980s, notably the campaigns to change management at Rank and Woolworths.

Nonetheless, on at least three occasions between 1991 and 1993, a coalition of institutional investors publicly undertook to remove a board of directors, and threats of similar interventions have prompted management changes in other recent cases. These recent interventions may suggest an increase in the willingness of institutional investors to take collective action, which in turn could reflect the growing concentration of share ownership.

The first of these battles was the 1991 effort by a coalition of institutions led by Norwich Union, one of Britain's largest insurance companies, to replace the board of Tace PLC.¹³⁷ This contest received widespread press attention, both because it was the first instance in recent memory in which negotiations broke down so thoroughly that the entire board was removed and because the institutional group was led by the chairman of the Institutional Shareholders' Committee. Press accounts branded Tace management as "profligate, inefficient and arrogant," and portrayed the contest as demonstrating the power of institutional shareholders.¹³⁸ Still, a closer analysis suggests that this was a battle that both sides stumbled into and from which the institutions emerged scarred and eager to avoid further public fights.

The circumstances surrounding the Tace fight were unusual in several respects. First, the company's founder and chief executive held a 23% block and apparently believed — incorrectly — that he could win a vote at a special shareholders' meeting. Second, the dispute centered less around poor financial results than around the very high compensation paid to Tace's founder. The battle was precipitated in 1990 when the outside director who had been the institutions' ally resigned, apparently after a falling out with the founder. The customary

¹³⁷ For pieces of the Tace story, see Norma Cohen, *Getting directors on board*, FIN. TIMES, Apr. 6, 1992, at 12; Richard Gourlay, *4.4% holding in Tace changes hands*, FIN. TIMES, June 24, 1991, at 18; Richard Gourlay, *Institutions launch bid to oust Tace board*, FIN. TIMES, May 4, 1991, at 10 [hereinafter Gourlay, *Institutions launch bid*]; Richard Gourlay, *Tace board quits at angry EGM*, FIN. TIMES, June 20, 1991, at 23; Price (1991) *supra* note 41, at 3. The description of the Tace battle in the text is based on these sources and on our interviews with some of the participants.

¹³⁸ Cohen (1992) *supra* note 137, at 12.

round of nonpublic meetings between large shareholders and Tace management failed, over the next year, to produce any results. Apparently, at some point a shareholder complained to the Bank of England about the remuneration paid by Tace to its founder. Sidestepping direct involvement, the Bank of England advised the shareholder to contact Norwich Union, which held 5% of Tace's shares.

Here, the plot thickens. Negotiations began between the institutions and the Tace board over the selection of a new chief executive officer. Then, without consulting the institutions, the Tace board chose a successor that the institutions found unacceptable, apparently because of his close associations with the founder. Insulted and also conscious of the surrogate role that Norwich Union had been delegated by the Bank of England, E.M. Sandland, Norwich Union's chief investment officer and the chairman of the Institutional Shareholders' Committee, quickly lined up two other institutional shareholders — Framlington and GT Management — to share the cost of a campaign to oust the Tace board. Framlington, which held 16% of Tace, stayed with the coalition over a several-month battle, but GT Management soon dropped out. Other institutions were kept in the coalition, according to Sandland, only through "active handholding" by Norwich Union.

Tace's management did not remain passive; it used its own investment bankers to contact shareholders and assembled a friendly 29% block of the stock. Then, in midcontest, an unaffiliated bidder announced an unsolicited tender offer, which touched off a bidding contest. This gave management a new argument: that the proxy fight should be shelved until the takeover battle was resolved. Despite these obstacles, Norwich Union assembled proxies from 40% of Tace's shareholders, called an emergency general meeting of the shareholders, and voted the board out of office at an acrimonious meeting.

The implications of the Tace battle can be read in various ways. Although the media lionized Sandland and Norwich Union as reformers, Sandland's actions were questioned by his own board and by many of his fellow fund managers. Although Sandland was defended by all insurance company officials that we interviewed, several fund managers either criticized him for "headline hunting" or disavowed his "un-British approach" that would embarrass the City. Victory was also bittersweet for Norwich Union, because it and Framlington were forced to split a £60,000 bill for solicitors' services. Other institutions declined to

share these costs. The Tace battle thus shows both the push-comes-to-shove power of institutional investors and the enduring significance of the free rider problem.

The significance of the Tace episode is further clouded by the fact that Tace was a relatively small company, with sales of only £36 million, and that Norwich Union was encouraged by the Bank of England. Further, given the difficulties that Norwich Union had in holding together a relatively small coalition, it is uncertain whether any single institution would be able to assemble and maintain the much larger coalition needed to challenge management at a major firm, such as General Electric Company, whose financial performance has been lackluster but whose sales total £9.5 billion.¹³⁹ Free rider problems might be ameliorated if an umbrella organization helped to form the coalition, but the Institutional Shareholders' Committee has withdrawn from playing such a role.¹⁴⁰

In a second public campaign begun by institutional investors in 1991, the chief executive of Brown & Jackson, a large British discount retailing chain, was ousted, and virtually all the firm's senior management were replaced.¹⁴¹ The apparent cause of the shareholder revolt at Brown & Jackson was a combination of poor operating results and a disastrous 1988 acquisition of an unrelated business from a selling group that included the ousted chairman. Institutional distaste for self-dealing may have been evident here, as in Tace. Initially, the institutions demanded that the entire board resign, but after Brown & Jackson switched to an investment banking firm that had the institutions' confidence, they agreed to a less drastic transition, in which the old board, and a new CEO picked by the outgoing CEO, would remain, but the new CEO would leave if the new financial advisor concluded that he should do so.

Perhaps because Brown & Jackson did not carry the fight to the bitter end, there was less fallout, and surely less cost, from the Brown & Jackson campaign than from the Tace campaign. But it is still potentially significant that the lead institution in Brown &

¹³⁹ See Clare Dobie, *Why laggard GEC needs new boss*, THE INDEPENDENT, Sept. 2, 1991, at 19.

¹⁴⁰ See *supra* section II.B.2.

¹⁴¹ For pieces of the Brown & Jackson story, see Neil Bennett, *Brown & Jackson to seek rescue approval*, THE TIMES (London), June 15, 1992, § 2 (Business), at 20; Alistair Blair, *A coalition versus a dictator*, FIN. TIMES, May 27, 1992, at 13; Norma Cohen, *New adviser at Brown & Jackson*, FIN. TIMES, Oct. 23, 1991, at 24; Norma Cohen, *Tough tactics behind the unit trusts*, FIN. TIMES, Aug. 5, 1992, at 15. The description of the Brown & Jackson campaign in text is based on these sources and on our interviews.

Jackson was Fidelity Investments Ltd., a subsidiary of Fidelity Group, the largest U.S. mutual fund group. Perhaps Fidelity, because it was foreign-owned and thus less subject to local conflicts of interest, felt less constrained in mounting a public campaign. Moreover, the Brown & Jackson campaign had a personal cost for Fidelity's chief corporate governance man, Alistair Blair, who was sacked not long thereafter — reportedly because "it was felt by [Fidelity's] marketing men . . . that such activity drew too much attention to Fidelity's investment failures."¹⁴²

Fidelity has, moreover, had losses as well as victories. In 1992, it vigorously opposed a debt restructuring at WPP Group PLC, the giant British advertising firm, arguing that the restructuring favored debtholders over shareholders. But Fidelity, which held 10% of WPP's preferred stock, was unable to muster enough support from other institutions to obtain the 25%-no vote needed to block the restructuring. With defeat imminent, Fidelity abandoned its opposition in return for the modest concession that the preferred shares would be represented on the new WPP board.¹⁴³

The most recent widely publicized fight was the 1993 campaign led by Prudential to install new management at Spring Ram.¹⁴⁴ Spring Ram's founder and CEO Bill Rooney, who owned 16% of its stock, had shown bad business judgment in pursuing new ventures in a recessionary climate. With earnings under pressure, he pushed Spring Ram's operating divisions and accountants to report good news, which led the accountants to resign and one division to falsify the numbers it reported to top management. When these problems surfaced, Prudential and other institutions informally urged Spring Ram to find a new CEO, but were rebuffed by Rooney and his handpicked board. Spring Ram did appoint a new finance director with strong ties to Prudential, presumably at the Pru's urgings, but after a further bad earnings report, Prudential (which held 12% of Spring Ram), Lazard Freres (which held 6%), Standard Life, and Barings decided that Rooney had to go.

¹⁴² Tim Blackstone, *Fidelity Goes Mad on Media*, EVENING STANDARD, May 1, 1992, at 35, available in LEXIS, News Library, Estand File; see also Blair (1992), *supra* note 141 (remarking, in an article offering advice to other activist investment officers: "Beware your own chief executive. Does it look wise, from where he sits, to put your firm in the spotlight?").

¹⁴³ For overviews of this dispute, see Melcher & Oster (1993), *supra* note 41; Pierre Tran, *Advertising Group WPP's Debt Plan Brings New Lease on Life*, REUTER LIBR. REP., Aug. 5, 1992, available in LEXIS, News Library, Reuwld File.

¹⁴⁴ For pieces of the Spring Ram story, see Andrew Bolger, *Hostages to declining housing market fortunes*, FIN. TIMES, Sept. 23, 1993, at 20; Andrew Bolger, *Rooney's future remains unclear*, FIN. TIMES, July 15, 1993, at 22; Weever & Amooore (1993), *supra* note 12.

Rooney continued to resist, but Prudential was able to amass the support of about a dozen institutions, collectively holding 35% of Spring Ram's stock — enough to replace the board if a proxy fight was required.¹⁴⁵ In the end, the board conceded. A new executive chairman chosen by Prudential was installed, together with a majority of new directors. As a face-saving gesture, Rooney remained as chief executive for several more months, but the new chairman had the board votes to sack him and did so several months later.

The publicized institutional campaigns at Tace, Brown & Jackson, and Spring Ram demonstrate that institutions, when they unite, can oust managements — but at a cost. When the parties bargain in the shadow of formal voting power, as they typically do, it is surely important that corporate managers know they will probably lose in pitched battle. Still, each episode involved a relatively small company; two cases — Tace and Spring Ram — raised issues of management integrity, to which British institutions seem particularly sensitive; and in one case — Brown & Jackson — the money manager leading the charge soon lost his job because the publicity displeased his boss.

E. The Process of Coalition Formation

For the researcher, the strong preference of British institutions for behind-the-scenes action raises questions about the frequency of this activity, how long the process takes, the costs and obstacles involved, and the issues around which institutional coalitions are built. The longer, more costly, and less effective the process of backstage negotiations, the more likely it is that the institutions will sell into the market, rather than organize to oppose management. Conversely, as institutional holdings grow, coordination costs decline, while the exit option becomes more costly because of the discount that an institution must absorb to sell its position.

The process of coalition formation and negotiation can be lengthy when the object is to oust a particular firm's managers. For example, the institutional efforts that forced changes in chief executives at Brown & Jackson and at Great Western Resources during 1992 (both of which were successful) "took a

¹⁴⁵ Prudential, Lazard Freres, Standard Life, and Barings were the only institutions named in press accounts and appear to have formed the core of the institutional opposition to Spring Ram management. The additional supporting institutions, recruited by Prudential when the coalition's initial efforts were rebuffed, played a smaller role in the campaign. We do not know how many of these institutions agreed to share the costs of a proxy fight and how many only agreed to vote with Prudential if a proxy fight took place.

year or more to unfold, during which time the share prices declined steadily."¹⁴⁶ The Tace affair also continued for nearly a year after institutional objections were first made; the Spring Ram ouster took upwards of six months. The time element raises the cost of building and maintaining a coalition. Moreover, once an institution joins a coalition, it will be expected to stand fast and not liquidate its stake in the company. Having assumed a leadership role, one loses face — within a cohesive community in which reputations are important — if one abandons the collective effort by selling one's stake.

The process of coalition formation inevitably begins with one or more fund managers deciding that a company is seriously underperforming — in a way that can be changed by shareholder intervention. Because the largest British institutions hold very diversified portfolios — Prudential, for example, estimates holding 900 U.K. stocks at any one time — recognition of a problem may itself be delayed. The trigger may be a public crisis or a falling stock price that is evident to all. Some institutional investors, however, do attempt a more elaborate monitoring relationship with their portfolio companies. Some insurance companies schedule regular review and consulting sessions with their portfolio companies. Our interviewees regularly cited Prudential as distinctive in its commitment to monitoring. Some referred to it as the "industrial statesman" of their community; the press has dubbed it the unofficial "High Sheriff of the City."¹⁴⁷ Prudential informed us that it generally meets with its portfolio companies twice a year — annually for smaller companies — for a detailed review.

Prudential's approach is not unique. Legal & General Group, another large insurer, estimates that it holds 500 meetings a year with corporate managements.¹⁴⁸ M&G, the unit trust firm, follows a similar policy. At these meetings, each institution regularly raises corporate governance issues, particularly issues involving board structure. Each notes its dissatisfaction if a company has too few nonexecutive directors. In contrast, most fund managers are reluctant to intervene with regard to specific business decisions. Some have said publicly that they do not believe in "bullying the board," and most stressed in private their own limited competence. "We are stock traders, not business consultants" was a recurrent refrain. In

¹⁴⁶ See Blair (1992), *supra* note 141, at 13.

¹⁴⁷ See Weever & Amooore (1993), *supra* note 12, at 5.

¹⁴⁸ See Dobie (1991), *supra* note 60, at 23.

their words, the City intervened "only when the company seemed to have lost its way."

Asked to describe how the process of intervention begins, the interviewees agreed that dissatisfied fund managers expect the largest shareholders to take the lead. The first step is usually a phone call or two from a large shareholder to the CEO or a nonexecutive director — or perhaps from an unhappy smaller shareholder to a larger shareholder, to see if the larger shareholder is willing to take action. Depending on the response to the initial contact, and on the seriousness of the situation, some fraction of these calls will be followed by further telephone calls, or by requests for face-to-face meetings. Other institutions expect an institution that was "overweighted" in the stock to take the lead in organizing joint shareholder action. *Overweighting* means that the institution owns a greater share of the specific company than it owns of the market generally. An overweighted firm has a greater incentive to intervene, because it will gain more from success than its competitors. In contrast, an underweighted firm is likely to remain passive, because any share price gains would help it less than its competitors, while it bore a disproportionate share of the costs.

Typically, if the matter progresses beyond a telephone call or two, the overweighted shareholder will arrange an informal meeting with management, which other institutions will probably not attend. Most interviewees agreed that this meeting would produce considerable information and a host of defensive responses, but little promise of change. Several pointed to the informational advantage that management has — "they can always give you detailed reasons why their case is exceptional" — and suggested that portfolio managers who debate business strategy with company executives risk "getting out of our depth." Portfolio managers are trained to be "good listeners," one remarked, not debaters. As a result, they said, portfolio managers typically rely either on a nonexecutive director or on the company's investment bankers for a more expert evaluation of the evidence than the portfolio managers are capable of themselves. Some interviewees stressed that they examined the board to see who among its nonexecutive directors they could talk to in confidence. Direct communication between institutional investors and outside directors seems firmly established in Britain, in contrast to the United States.

If the institution is dissatisfied with the response it receives, it can solicit support from other institutions. However, before taking this step, one leading fund manager suggested, the institution might

ask management to arrange a meeting for it with the nonexecutive directors and the firm's financial adviser. "Don't underestimate the power of a 3% shareholder; if you have 3%, you have clout," we were told. Even such a request — or its suggestion — may cause management to become more responsive.

Others, however, opined that before an institution requests a meeting with the independent directors, it needs to show that it is not an isolated dissident — that "it speaks for the shareholders." Some have publicly estimated that an institution needs to line up 10% -15% of the company's stock before requesting a formal meeting — or before the board will pay serious attention.¹⁴⁹ In most of the incidents recounted to us, the instigator of the coalition had assembled an even larger percentage of the shares before asking for a meeting with the board. One prominent fund manager described to us an instance in which it lined up four other institutions, who with it collectively held 30% of the corporation's voting stock, and was able without publicity to secure the resignation of the firm's CEO.

One prerequisite to forming a coalition to replace the CEO was commonly noted by our interviewees. It is often not enough, they said, to decide that "the CEO must be sacked"; rather, the institutions need to find a "savior" — someone who can turn the company around.¹⁵⁰ If not, it may make more sense for the institution to sell, or to try to convince the board to search for a successor. Often, this issue can be discussed in confidence with the corporation's financial advisor. In a few instances, institutional investors have even formed a coalition with the firm's financial advisor to seek to replace the incumbent chief executive.¹⁵¹ In other instances, the institutions will propose that the company retain a different financial advisor, who will prepare a recapitalization plan.

Most of the time, the institutions will never form a coalition. One or more unhappy institutions will communicate their concerns to management or to trusted nonexecutive directors; and press stories may appear stating that "institutional shareholders" are seeking such and such a change. The board will get the message, and either some

¹⁴⁹ See Blair (1992), *supra* note 141, at 13.

¹⁵⁰ In the Tace battle, for example, Norwich Union was seeking to restore Michael Beckett, a former CEO of Tace, to office. See Gourlay, *Institutions launch bid* (1991), *supra* note 137, at 10. Similarly, at Spring Ram, Prudential knew whom it wanted as the new CEO — an executive who had turned around another company in which Prudential had invested — before it provoked a showdown with the board. See Weever & Amooore (1993), *supra* note 12.

¹⁵¹ An example is the 1991 revolt of institutional investors at Granada Group. SG Warburg, financial adviser to the firm, apparently joined institutional investors in deciding that the CEO should be replaced, in part as the price for completing a rights issue that the investors had resisted. See Raymond Snoddy, *Sacrifice to woo the franchise gods*, FIN. TIMES, May 11, 1991, at 10.

change will take place or financial results will improve, diminishing the urgency of change. Sometimes the institutions will get what they want, but often the outcome will be a compromise. For example, a firm, instead of ousting the CEO, may appoint a new nonexecutive chairman, finance director, or financial adviser, or promise to elect more nonexecutive directors and to consult the institutions when choosing these new directors. The institutions' willingness to compromise reflects a number of factors, including their own uncertainty about the best course of action, the cost and difficulty of building a coalition to press for more than the company is offering, and their strong reluctance to take public action.

The most important question about the behind-the-scenes activism of institutions is, of course, the frequency of such activity. Little data exists on this question. The tip of the pyramid is a CEO sacking. Piecing together various sources, there seem to have been at least ten companies, in addition to Tace, Brown & Jackson, and Spring Ram, at which institutional shareholders engineered top management change over the 1991-1993 period.¹⁵² The rough total of thirteen can be taken as a plausible lower bound, but we do not know how much the press missed.

One can also ask how often a particular institution intervenes, or is solicited to intervene by other institutions. In 1991, testifying before the House of Commons, Michael Sandland, the current chairman of the Institutional Shareholders' Committee, was asked "how often the institutional shareholders are using this threat [of removing the board]?" He answered that he did not know what other institutions were doing, but was pressed to estimate how often his firm had engaged in such a threat. He responded:

We saw over the last year there have been two, possibly three, confrontations which have reached public notice. As to the numbers of serious or possibly robust discussions which have not surfaced in the press or wider public I find it very difficult, maybe a dozen.¹⁵³

Following up on this estimate, we asked all our interviewees how often they had been approached within the last twelve months to join

¹⁵² See Blair (1992), *supra* note 141 (naming Great Western Resources); Jackson (1991), *supra* note 10, at 18 (reporting the ouster of the Budgens chairman at the instigation of Electra, IEP, and Gartmore; also naming Asda and Scicon); Walsh (1991), *supra* note 19, at 9 (reporting that the Granada CEO was replaced to enable a rights offering to succeed, and that Schroders was the key figure in the investor revolt); Weever & Amooore (1993), *supra* note 12 (naming Pentos, Alexon, BET, Bunzl, and Amber Day). In a few of these cases, press accounts name only unidentified institutional investors, and there is some ambiguity over whether the board acted on its own, or only because it was pushed.

¹⁵³ TAKEOVERS AND MERGERS, *supra* note 94, at 278.

an informal coalition to pressure a company's management or board for specific changes or reforms. The highest estimate we received was from the activist fund manager who told us not to underestimate the power of a 3% shareholder. He said that his firm had received six such requests within the past year. In two cases, this process resulted in the coalition's indicating to the board that it intended to convene an emergency general meeting to remove board members, as in Tace. In each of these two instances, the threat worked, the desired management changes were achieved, and no special meeting was called. A major insurer, in contrast, although widely recognized as an activist within its peer group of leading investors, reported that it had joined an institutional coalition only once or twice a year over the past two years. However, this insurer also had as many as twenty discussions a year with one or more other institutions about the need to "strengthen the boards" firms in its portfolio.

Several factors could explain the different behavior of these institutions. One involves the composition of their respective equity portfolios. The insurance company invests heavily in Britain's largest companies, while the activist fund manager specializes in emerging, higher- technology growth companies. It is harder to build a coalition to remove the CEO of a major British corporation than in the case of a smaller firm, and much harder to keep the coalition out of the public eye. The effort will take more time, more effort, more legal and investment banking fees, and pose a greater risk of reprisal from management's allies. These concerns may outweigh the larger financial gains that are possible by improving a larger firm's management. Second, for smaller companies, a coalition of four or five investors, who are often in regular contact anyway, may already hold a large enough block to be virtually assured of success. In contrast, to be decisive at a major firm, a shareholder coalition would have to have more members. Third, fraud, self-dealing, and gross managerial incompetence may simply be more frequent for emerging companies than for well-established firms. Finally, because of the insurance company's size and prestige, its own voice may carry sufficient "clout" with the board, even without a coalition behind it, but with the implicit threat that a coalition could be built.

Other institutions, when asked how often they had joined or been approached to join a shareholder coalition, sought to redefine the question. One large fund manager drew a distinction, similar to that offered by Sandland, between conferences with a group of other institutions about a specific company and a coalition that actively opposes the board. The manager estimated that the fund participated in a dozen private conferences a year with other institutions

concerning British companies, but rarely was involved in active confrontation with a board. To call an emergency general meeting of shareholders, the manager said, was an "extraordinarily rare step."

Our interviews also probed for differences in behavior between externally managed corporate pension funds and the quasi-public pension funds associated with formerly nationalized industries, which have either an in-house staff or a long-term relationship with an essentially captive adviser. Few major differences emerged. The in-house manager of a quasi-public pension fund described itself as having received "less than six" requests to join such a coalition over the past two years. Given this fund's activist reputation, it would seem a logical candidate for another dissatisfied institution to contact. The fund had itself on two occasions within the last year sought to assemble an institutional group to persuade firms to add nonexecutive directors to their boards. In general, the quasi-public pension funds expressed a stronger interest in intervening with regard to general corporate governance issues such as board structure, even when the subject corporation is performing well, than did fund managers who were affiliated with merchant banks.

All in all, the formation of institutional coalitions can be described as an out-of-the-ordinary event — neither extraordinary nor frequent. Informal contacts with management or the board that never reach the stage of coalition building are more frequent — we have heard estimates as high as thirty to forty times per year — but still reach only a small percentage of British firms in any given year.

Interviewees were also asked how large an institutional coalition could be cohesively assembled. Florence and Scott had theorized that the largest twenty shareholders could act, in Scott's phrase, as a "controlling constellation."¹⁵⁴ The interviewees estimated that forming and maintaining a cohesive group became much more difficult above about five or so members. The largest group that we know of is the dozen institutions that supported Prudential in the Spring Ram episode — when Prudential, perhaps wishing to avoid a repeat of the Tace controversy, may have assembled a large group to convince a recalcitrant board not to fight to the bitter end. Yet even here, there were only four lead institutions named in the press accounts who, when the need arose, assembled a larger number of less active supporters.

What types of issues trigger the formation of a coalition? Most interviewees responded that it usually took a financial crisis, including a sharp decline in share price, or an event personally discrediting

¹⁵⁴ SCOTT (1986), *supra* note 101, at 87.

management to provoke the institutions into action. One fund manager suggested that coalitions could be formed to reverse excessive diversification or to encourage the disposition of unnecessary or unprofitable assets — "unbundling" in the current British parlance — but we are not aware of any instance in which a coalition has been formed with this as its principal goal. Only quasi-public pension funds such as Postel and the National Coal Board described themselves as interested in seeking corporate governance reforms unrelated to any change in management or strategic plans.

Lastly, our interviewees were invited to address when they would intervene in a portfolio company's affairs and when they would simply sell. Several responded to this question by focusing on the size of their position — the smaller the position, the more attractive the exit option would be. But it was clear that exit was a preferred strategy for many. A comment by one major fund manager conveys the attitude of many of his colleagues:

[A] dissatisfied portfolio manager will sell off if he doubts the quality of a management. I would estimate that sale is far more frequent than any . . . attempts to become involved in corporate governance. There is at least a 10:1 ratio of sale over crisis talks or group action or involvement. Group action occurs when there is an unexpected crisis (either a performance crisis or a corporate governance crisis). Both occur, but the interests of our clients lead us to prefer taking the earlier step of selling when we sense future problems, rather than waiting for a crisis. We try to prevent a crisis or sell before it.

F. *Summary*

To the extent that our interviews can provide a look behind the curtain, they suggest the following generalizations.

1. For most British institutions, activism is largely crisis driven. The largest insurance firms — Prudential, Norwich, and Legal & General — and a few large unit trusts — chiefly, M&G — engage in regular proactive monitoring and press for governance changes independent from a financial or operational crisis. But they have limited resources and focus their efforts on poorly performing firms. The prospering public corporation can resist corporate governance reforms, if it wishes, with little fear of institutional intervention.¹⁵⁵

¹⁵⁵ Guinness, for example, recently elected a single chief executive and board chairman when its old chief executive retired, despite institutional pressure to separate the two positions. See Jane Simms, *Management: Investor pressure builds on all-in-one executive*, THE INDEPENDENT, Aug. 16, 1992, at 19. Similarly, Marks & Spencer recently combined the two positions after earlier separating them. See Dobie (1991), *supra* note 60.

2. The rate of shareholder interventions to replace management appears to have risen in the last few years. This increase in activism could reflect increased shareholder concentration, but it could also be a cyclical response to the severe recession that plagued the British economy until recently.¹⁵⁶

3. With proxy fights rare and difficult to pull off, an important source of institutions' power is their ability to reject a subscription offering. Preemptive rights, which strike those schooled in finance theory in the United States as unimportant, are central to U.K. corporate governance. The effectiveness of this weapon depends on laws and stock exchange rules protecting preemptive rights.

4. Absent a generally accepted mechanism for cost sharing, even successful proxy battles, such as the Tace affair, can seem like Pyrrhic victories to the institutions leading the charge. They will be rare and conducted more for their deterrent value, or to respond to unethical management conduct, than in the hope of direct profit.

5. Despite these obstacles, institutional coalitions — usually small in number of participants but with substantial collective shareholdings — do form. Their threat to oppose management and even remove the board is credible and has repeatedly resulted in CEO resignations.

6. Whenever possible, the institutions prefer to operate in the shadows. The prevailing view, even among activist managers, is that "secrecy and trust are essential."¹⁵⁷

These conclusions may seem to produce a paradox: institutions are highly reluctant to engage in public proxy battles, but corporations consider the institutions' threat to employ such a weapon credible. The paradox, however, is only superficial. There are other well-understood contexts in which one can credibly threaten a step that will make one worse off. One such situation is when, by so doing, one can force one's adversary to incur even greater expected costs. This is the theory of nuisance litigation: if the plaintiff by expending \$1 can force the defense to expend \$3, then the plaintiff may be able to secure a settlement even in a weak case when the plaintiff would not want to incur the expense of a trial.¹⁵⁸ In the governance context, whatever the costs of intervention to the institutions, the threatened

¹⁵⁶ As Michael Sandland of Norwich Union put it in commenting on the recession's impact on institutional activism: "At the start of the '90s, the tide went out. You walked along the wet sand and found unmentionable things left behind." See Makin (1992), *supra* note 127, at 135.

¹⁵⁷ Weever & Amore (1993), *supra* note 12, at 5 (quoting Michael Bishop of Gartmore).

¹⁵⁸ See D. Rosenberg & S. Shavell, *A Model in which Suits are Brought for their Nuisance Value*, 5 INTL. REV. L. & ECON. 3 (1985).

managers of their portfolio companies have even more at stake. They stand to lose jobs, perquisites, and professional reputations. Hence, they are not eager to completely rebuff institutions, and gamble that the institutions are bluffing, when the institutions threaten a voting contest.

Moreover, the institutions may not be bluffing. In a repeated game context, where the reputation you build today is critical to future success, major institutions might pursue a proxy fight that is uneconomic apart from its deterrence value for future cases. Indeed, the need to preserve one's reputation can be used as a tactical weapon to convince a recalcitrant board not to force the matter to the end stage of a proxy fight. For example, by going public in Spring Ram, Prudential, and Lazard Freres put themselves in a position in which a proxy fight became preferable to surrendering to Spring Ram's management.

This analysis — that both sides can lose from voting contests — can explain the strong preference for behind-the-scenes settlements. Both sides have reason to threaten steps that are costly to them, hoping that a bluff will work. Publicity may lock either or both sides into positions they would prefer only to hint at and not overtly threaten. By bargaining in the shadows, costs, including reputational damage to individuals and institutions, can be minimized.

V. THE LIMITS ON INSTITUTIONAL ACTIVISM

This Part will examine in greater detail the factors that affect the formation of institutional coalitions and other forms of institutional involvement in corporate governance. Our interview data suggests that coalition formation is relatively infrequent and that coalitions are small, rarely more than four or five members. Moreover, many British firms persist in practices — notably diversification with poor results — that could elicit institutional objection, but generally do not. Instead, the limited resource of institutional attention is focused on the worst performers and on cases tinged with scandal or self-dealing.

A. Direct and Indirect Costs of Coordination

As noted earlier, Norwich Union and Framlington were forced to divide a £60,000 bill for the Tace proxy fight. Collectively, these two firms held roughly 20% of Tace. They had obtained the proxies of an additional 20% — but not the agreement of these other

shareholders to share expenses.¹⁵⁹ This fact pattern underscores two distinct problems:

First, there is the classic free-rider problem. Even with a substantial 20% stake between them, Norwich Union and Framlington would have to value the gains to Tace from replacing the old board at more than £300,000 before incurring a £60,000 cost would make economic sense, even if ultimate success were certain. This may help to explain why activist institutions usually try to develop a 15%-20% coalition before seeking a formal meeting with outside directors. A request by a smaller group would be less credible, in part, because a small group is unlikely to be willing to incur significant expenditures. A successful effort to obtain control of the board may lead to expense reimbursement, but this did not happen in Tace because an independent bidder acquired the firm. Moreover, campaigns not directed at control do not carry even the possibility of expense reimbursement, though costs are probably lower as well.

The economics of a proxy campaign look better if one considers that the investors' action will demonstrate their credibility and deter managers of other firms from engaging in conduct adverse to shareholder interests. Nonetheless, the smaller the stake, the greater the expected gain must be before shareholders can justify incurring any costs. Moreover, much of the benefit from general deterrence will flow to one's competitors. Yet, as we discuss below, many money managers care as much about relative performance as about the absolute return on monitoring expenditures.

Second, the Tace battle underlines the difficulty that institutions face in seeking agreement on cost sharing, even if they agree on the desired substantive outcome. One problem, our interviewees told us, is that pension fund managers lack the authority to spend pension assets on a proxy campaign. Of course, a fund manager could request authority from pension trustees, but this puts the fund manager in a doubly uncomfortable position: (i) perhaps implicitly warranting the success of the intervention, and (ii) having to justify the proposed actions to pension fund trustees who themselves may be corporate officers and potential targets of such activism. Our interviewees stressed that pension fund management is intensively competitive. In addition, a successful fund manager will have many clients, making it time-consuming to solicit the consent of each. As a result, fund managers rarely ask pension fund trustees for an additional contribution to fund governance activism.

¹⁵⁹ See *supra* notes 137-39 and accompanying text.

If proxy campaigns were common, fund managers could seek such authority *ex ante* as part of their basic contract. But up to now, overt action has been infrequent. Moreover, there are advantages to being unable to contribute to a campaign oneself, when others are not so constrained.

If a pension fund manager does not seek reimbursement from its clients for expenses, then the expected benefit must be huge to justify the manager incurring any expense. Assume for example that: (i) a pension fund manager holds a 1% stake worth £10 million in a particular firm; and (ii) the proposed intervention will raise the value of this holding by 10%, or £1 million. It is in the clients' interest to contribute £30,000 to a joint shareholder fund to finance the intervention. But is it in the fund manager's interest to do so?

U.K. fund managers are typically compensated, like their U.S. counterparts, on the basis of a percentage of funds under management, and incentive compensation is rarely used. Suppose that a manager receives an annual fee equal to 1% of the assets it manages.¹⁶⁰ A £1 million increase in the fund's asset value will increase the fund manager's annual fee by £10,000. This expected but uncertain annual gain of £10,000 may or may not induce the fund manager to advance £30,000 of its own, but clearly its incentives are different from those of its clients, whose expected gain is £1,000,000. In short, agency costs at the fund-manager level can result in underfunding of collective action that it would be rational for the investors in the fund to undertake.

To be sure, a fund manager that undertakes successful shareholder interventions may attract new clients and thus increase funds under management. But other fund managers also benefit from the successful intervention, so the fund manager's relative performance versus his "free riding" rivals may not be improved. Also, a reputation as a shareholder activist is a dubious marketing tool in a world in which corporate managers, who may be skeptical of such activism, control most pension fund assets.

This agency-cost explanation for passivity may partly explain why British insurers have been, on the whole, more activist than pension fund managers. Because they primarily manage their own money, they need only consider whether the costs of activism are

¹⁶⁰ Actual pension management fees are usually lower than this. See Cohen, *supra* note 56, at 6 (typical "pure" charges are 0.2%-0.5% per year; smaller accounts and accounts invested in overseas assets may pay total fees of up to 1% per year).

justified by the direct benefits to them as investors (rather than as agents of investors).

That many British insurers are mutual companies could also help to explain their relative activism.¹⁶¹ Mutual companies have no shareholders and thus may thus be less subject to cost constraints that limit their activism as investors. Their managements may have discretion to pursue policies, including corporate governance policies, that they consider correct, even if this means bearing some costs for free riders. In this freedom from shareholder oversight, British mutual insurers parallel to a degree U.S. public pension funds, which have been the most active American institutions. Although we do not mean to suggest that the solution to corporate governance problems is to insulate the watchers from market oversight, it is ironic that some of the most active monitors in both the United States and Britain are, to varying degrees, exempt from such oversight themselves.

In theory, incentive compensation can reduce these agency-cost problems. A fund manager who turns around a portfolio company might receive, for example, some percentage of the gain — say 10% — instead of a few basis points. In the United States, incentive compensation for fund managers is limited by SEC rules,¹⁶² but in the United Kingdom, there is no legal prohibition on incentive compensation. Yet incentive compensation is rarely used. When we asked fund managers why, the most common explanation involved the clients' predictable response when the topic was raised. Clients ask "what they get by paying more." The fund manager cannot promise that clients who pay incentive compensation will receive higher returns or better service than other customers without offending the latter — and possibly legal rules as well. Because all clients must be treated more or less alike or the disfavored will leave, the manager must convince most clients to pay the incentive compensation or else stay with a standard fee structure. This may be more trouble than it is worth. Perhaps too, though they did not say so, fund managers know that clients will want incentive compensation to be a two-way street, and prefer to charge less risky, asset-based fees.

The indirect costs of shareholder activism may be even more important than the direct costs. Forming and maintaining a shareholder coalition takes a substantial amount of time. Diplomatic niceties require that contacts between institutions be conducted by

¹⁶¹ Norwich Union, for example, is a mutual.

¹⁶² Investment Advisers Act Rule 205-3, 17 C.F.R. § 275.205-3 (1993); *see* Coffee (1991), *supra* note 3, at 1362-66.

senior executives. The time so consumed reduces the time available to contact existing or prospective clients or review other stocks in the institution's portfolio. One veteran of these battles believes that the institution seeking to assemble the coalition must win the support of "three of the top five institutional shareholders in the company" in order to form a minimally credible coalition.¹⁶³ But this only begins the process. The investment officer who is seeking to form the coalition must also meet and consult with (1) the company's management, (2) his firm's clients, (3) other senior officers within his own institution, and (4) potential allies among institutional investors. The investment officer must convince his firm's senior management, the firm's clients, or both, to commit funds for professional fees. Resistance from both groups is common.¹⁶⁴

The effort to win the support of uncommitted institutions will consume still more time. Both sides are apt to hold meetings with them. The company will then most likely announce some changes and reforms. But are these reforms substantive or only cosmetic? All members of the embryonic coalition will need to confer over this question, and some may drop out. Meanwhile, the company will unleash its own solicitors and investment bankers. If the dispute becomes public, the media will be drawn into the fray. All this for a dispute involving only one stock in the portfolio of an institution owning, in all likelihood, several hundred stocks. There is also an important hidden cost: other company managers may become less open with your institution because they fear that if you learn adverse information, you may demand a management shake-up.¹⁶⁵

Inevitably, these costs must be passed on to clients in some form. Meanwhile, rival firms can free ride on the activist fund manager's efforts, while focusing on their core business of securities research and stock picking.

B. *Conflicts of Interest*

Many pension fund managers are affiliated with merchant banking firms. If the parent merchant bank represents a company in the fund manager's portfolio or a firm involved in a takeover bid for that company, an actual or potential conflict of interest exists. All fund managers are always seeking new corporate business, and merchant banks are always seeking new securities underwriting

¹⁶³ Blair (1992), *supra* note 141, at 13.

¹⁶⁴ *Id.*

¹⁶⁵ *Id.*

clients. Mutual funds, too, often seek to manage pension money. When soliciting corporate clients, a reputation as a troublemaker is something devoutly to be wished on one's competitors and avoided for oneself. A merchant bank's optimum public profile, in the words of one banker, is "below the level of the floor."¹⁶⁶

Thus, it is not surprising that in Britain, as in the United States, most corporate pension plans follow a variant of the golden rule: "Do unto other companies as you would have their pension funds do unto your company."¹⁶⁷ In other words, support management. British corporate pension plans are not subject to even the minimal regulatory oversight provided in the United States by the Department of Labor, which requires that pension plan trustees cast informed votes and vote in the interests of plan beneficiaries, not the corporate sponsor.¹⁶⁸

As some interviewees remarked, some of the most active pension fund and mutual fund managers have foreign parents and are less affected by these conflicts. For example, Gartmore (affiliated with Banque Indosuez, a French investment bank) and Phillips & Drew (owned by Union Bank of Switzerland) are among the most active pension fund managers, and Fidelity Investments Ltd. (affiliated with U.S.-based Fidelity Group) led the Brown & Jackson campaign.

In contrast, several interviewees suggested that the relatively low profile on corporate governance issues of Mercury Asset Management, the largest British pension fund manager, reflected its status as a 75%-owned subsidiary of SG Warburg, a major British investment bank. A high profile might cost both Mercury and Warburg some current or future clients. There was also a potential for embarrassment if Mercury disagreed with Warburg's advice to a corporate client. Possibly as a result, Mercury, we are told, prefers not to keep voting power for the shares it manages. Yet what counts as relative passivity in Britain might be considered activist in the United States — Mercury recently joined a group of institutions that successfully demanded management change at Alexon Group as the price of a rights offering's success.¹⁶⁹

¹⁶⁶ Weever & Amore (1993), *supra* note 12, at 5.

¹⁶⁷ JAMES E. HEARD & HOWARD D. SHERMAN, *CONFLICTS OF INTEREST IN THE PROXY VOTING SYSTEM* (Investor Responsibility Research Ctr. 1987); O'BARR & CONLEY (1992), *supra* note 40, at 200; *see also* Black (1990), *supra* note 2, at 595 - 98.

¹⁶⁸ *See* INSTITUTIONAL SHAREHOLDER SERVICES, INC., *THE ISS PROXY VOTING MANUAL* 1.7-1.21 (3d ed. 1993) (reviewing Department of Labor guidelines).

¹⁶⁹ *See* Roland Rudd, *Institutions force management change at Alexon Group*, *FIN. TIMES*, Apr. 23, 1993, at 19; *see also* Weever & Amore (1993), *supra* note 12, at 5 (reporting on Mercury's role in pushing out the founder and CEO of Pentos).

There is little evidence of overt corporate retaliation or pressure on the more active institutions. British commentators largely discount the possibility that pension plan trustees — even though they are often the corporation's own officers — would directly seek to influence how an external manager votes.¹⁷⁰ Although a merchant bank's self-interest may counsel passivity even without overt pressure from its clients, there is a countervailing pressure: relative performance is the principal benchmark of success in competing for pension accounts. Some activist firms, notably Fidelity and Gartmore, have attracted substantial business away from older, more established firms.

In the United States, some companies have chosen to keep voting in-house. Outside money managers pick stocks; corporate officers vote them. The self-evident purpose is to ensure promanager votes. Splitting stock-picking and voting in this way appears uncommon in Britain. However, conflicts may underlie the common requirement that pension fund managers consult clients before they cast "contentious" antimanager votes or spend plan assets on a governance campaign. A contract that discourages activism is likely to be congenial to corporate managers, who may worry that activism will be targeted at them.

Although the conflicts issue rears its head most noticeably in the case of pension fund managers, insurance companies are not immune, partly because they are active pension fund managers. In the early 1990s, Prudential ran an advertisement in newspapers stating that out of 480 tender offer bids since 1984, it had failed to support management in only around twenty-five cases. Referring to this ad in testimony before the House of Commons, Michael Sandland of Norwich Union responded that out of 385 tender offers since 1984, Norwich had failed to support management in only eleven cases.¹⁷¹ Both these statistics and the marketing effort to present them to the public suggest the possibility of compromised loyalty.

C. The "Race to the Exit" Scenario

Several interviewees stressed that one danger in assembling a shareholder coalition was that approaching others to join a coalition

¹⁷⁰ See RICHARD MINNS, *PENSION FUNDS AND BRITISH CAPITALISM* 104 (1980) ("[V]oting is in effect what the managing institutions choose to make it."); SCOTT (1986), *supra* note 101, at 25. Under the Trustee Investment Act, virtually all trustees, including pension plan trustees, must have advisers qualified to provide written advice on proposed investments. Scott argues that this strengthens the hand of the external manager. *Id.* at 31 n.43.

¹⁷¹ TAKEOVERS AND MERGERS (1991), *supra* note 94, at 278.

would trigger a race to sell among institutions. As they viewed it, the information that a major shareholder was dissatisfied had an overhang effect: the proponent might sell its stock if it did not secure satisfactory reforms, thereby depressing the stock's price. Such an overhanging block could induce other investors to sell first. This danger forces institutions to be careful whom they invite to take collective action, lest the invitations trigger a "race to the exit."¹⁷² This worry forces the coalition builders to narrow the field of potential partners, thus further complicating the process of forming a coalition. Most considered selling in such a setting to be unethical and possibly to constitute unlawful insider trading.¹⁷³ They insisted that they and their usual allies would not sell their shares if so approached, but strongly implied that others might not be so ethical.

In the U.S. securities market, with its greater dispersion of ownership, the information that a 3%-5% shareholder may soon sell seems likely to have only a modest impact on share price, unless the blockholder is thought to possess inside information. Within the more cohesive and institutionally dominated U.K. market, knowledge of a large institution's impending sale could plausibly trigger a sell-off by other institutions if either: (i) other institutions believed that the selling institution had adverse private information about the company; or (ii) liquidation of the institution's block would significantly alter the balance of supply and demand for the stock, producing a short to medium term price decline.

For example, if Prudential asked other institutions to join with it to change a particular company's managers, the institution receiving such a request might assume that Prudential — which regularly meets with company managers — had reasonable grounds for dissatisfaction. The process of management change could take from several months to more than a year to unfold, during which time negative assessments of the company would appear in the press, and its stock price would

¹⁷² One fund manager phrased this concern as follows:

You must remember that in communicating dissatisfaction, you are possibly giving a signal of your future intentions. Would the person you are talking to abuse the information by trading on it? You have to fear a race for the exit in which you will be last by staying to challenge management.

¹⁷³ Section 57(2) of the recently passed Criminal Justice Act 1993 defines insider to include shareholders. See 30 HALSBURY'S CURRENT STAT. (1994), *supra* note 83, Money tit., at 15 ("[A] person has information from an inside source if ... he has it through ... being a director, employee, or shareholder."). Commentators have noted that this provision "cover[s] cases where ... a shareholder declines a secret approach to sell his stake to a potential bidder but nevertheless trades on the basis that a forthcoming bid for the company is likely to be made." Wotherspoon (1994), *supra* note 83, at 425.

likely fall. On the other hand, disclosure of the formation of an institutional coalition to revitalize a slumping company could increase the target's share value, much like a rumor of a takeover or a control contest. It is an empirical question whether the gains are larger from selling or from fighting, and we have no reason to second-guess fund managers' belief that negative price pressure will dominate at least some of the time.

D. "*Underweighting*" as a Cause of Passivity

We have already noted that "overweighted" institutions are expected to take the lead role in shareholder intervention, and underweighted institutions are unlikely to participate in a shareholder coalition. Prudential, the largest British institution, holds around 3.5% of all publicly traded British equities. As a mathematical necessity, Prudential's average holding in public corporations *that it invests in* will be at least 3.5%. It will hold more than a 3.5% stake in some firms and less than a 3.5% stake in others. In the former case, it is said in the parlance of the City to be "overweighted," and in the latter to be "underweighted."

It is no surprise that firms that have large percentage stakes tend to be the activists that organize shareholder coalitions. A larger stake gives them a larger incentive. Overweighting certainly correlates with a large percentage stake. But why should underweighted firms necessarily be passive? After all, an institution could be underweighted in a corporation, and yet still hold 2%- 3% of the corporation's shares and be among its largest shareholders.

The passivity of underweighted institutions has a clear economic logic: Institutions are locked in a competition for investors' funds, which turns largely on relative performance. Thus, no institution wants to help its competitors at its own expense. A firm that shares the costs of a shareholder coalition when it is underweighted will benefit not only the usual free riders but, more importantly, rivals who are fully weighted or overweighted in the stock. For example, a fund manager that turns around a company in which it owns a 2% stake, compared to a 3% stake in the market, gains less than half as much *in relative terms* as a smaller rival that owns 1.5% of the company but only 1% of the market.

Once again, action that would benefit the manager's clients is chilled because it does not benefit the manager. Nor can incentive compensation solve this problem, as long as compensation depends on *relative* performance. Restricted diversification would make a manager more likely to be overweighted in the firms *that it invests in*, but a

manager as large as Prudential may, almost of necessity, own most of the British market and thus be underweighted in many firms.

If one takes the logic of over- or underweighting to its logical conclusion, an underweighted fund manager may not even want to improve a portfolio company's performance. Presumably, the manager will hold such a stake principally for diversification or to be a closet indexer who cannot outperform or underperform competitors by very much. Our interviewees did not express this heretical view — that one might be indifferent to whether a portfolio company does well. A money manager's active expression of this perspective would also violate fiduciary duties and cultural norms and might boomerang if clients became aware of the behavior. Still, this perspective underscores the reluctance of underweighted firms to participate in a shareholder coalition.

E. Coalitions Among Rivals

More generally, competitors may simply find it hard to cooperate. The most important British institutional investors — insurance companies and pension fund managers — compete intensely for investor funds. It is impossible to verify whether the natural rivalry between competitors affects their ability to cooperate, when they have common corporate governance interests, but some interviewees felt that this factor created a psychological barrier to cooperation. Moreover, the logic of over- and underweighting often causes interests to diverge as well.

Concerns like these might explain why British institutions are reluctant to nominate their own slates of directors. Gartmore's fund managers might feel uneasy about placing Robert Fleming's nominees on the board of a company in which Gartmore holds a substantial stake, for fear that Robert Fleming would gain an informational advantage. Such an advantage need not involve actionable — and unethical — insider trading. Directors inevitably have better soft information about a company's prospects and can convey that information, or a resulting buy or sell recommendation, to traders in a variety of low-visibility ways.

F. Legal Barriers

Legal rules can affect the institutions' choice between holding debt and equity, the size of the stakes that the institutions own, and what they can do with those stakes. The effects are interrelated — institutions that are limited in what they can do have less incentive to

own large, influential stakes. Britain today has few significant obstacles to owning equity or to holding large stakes, and only loose constraints on what the institutions can do.¹⁷⁴

The principal legal concerns are insider-trading liability and control-person liability. The institutions' fear of inadvertently receiving inside information, which would prevent them from trading, inhibits communication between shareholders and managers. Adverse publicity is also a concern: no one wants to be publicly accused of unethical behavior, even if no legal liability results.

Insider-trading related impediments to information flow can both limit and channel institutional oversight. Less-informed institutions, recognizing their own ignorance, will take action only in clear cases. They will tend to favor structural reforms, such as independent board chairmen, over intervention in specific corporate decisions. But without insider trading restrictions, major shareholders might use an informational edge, not to improve oversight, but instead to earn short-term trading profits.

Although insider-trading concerns *could* inhibit money managers from serving as directors, such concerns seem a weak explanation for why money managers do not sit on corporate boards. One could construct a Chinese wall to shield the director from the institution's traders, and the threat of litigation is low in Britain to begin with.

A second potential legal concern is control-person liability. Although there is little caselaw, the perceived risk depends both on what you do and on how much you own. Some commentators suggest that institutions do not want to nominate board members or get too involved in a company's business decisions, because of this potential liability.¹⁷⁵ Most of our interviewees denied that control-person liability entered their thinking, but this potential liability could reinforce the reluctance of some to hold very large (over 10%) stakes.

The principal reasons why few money managers sit on corporate boards seem to be nonlegal. Those interviewed stressed that they lacked the expertise to make or review decisions for industrial companies. Other reasons include lack of need, because major

¹⁷⁴ We discussed industry-specific rules in Part II and the general framework of company law and securities regulation in Part III; we do not repeat that discussion here.

¹⁷⁵ See, e.g., William Kay, *Money men who rule the business world*, THE TIMES (London), Apr. 20, 1992, at 25 ("Fund managers ... are still frightened of being accused of trying to run the companies in which they invest. There is a legal reason for that. An outsider deemed to have a direct influence in how a company is managed can be as liable as the directors for any wrongdoing.").

shareholders can already speak directly to corporate officers and nonexecutive directors; lack of time, because senior executives at major institutions can only serve on a few boards, and even that comes with a cost in attention to clients and to other, perhaps more troubled firms; and a desire to maintain objectivity and not become loyal to a stock that a neutral observer would sell.

G. *The Role of Political History*

Mark Roe has reported that much industry-specific regulation adopted in the United States since the late nineteenth century was expressly intended to weaken the power of financial institutions as shareholders.¹⁷⁶ This American history raises the question of whether a similar story can be told in Britain. Researching the political history of legal controls on different financial institutions in Great Britain is a massive task; we offer here only such clues as we have found in the course of our research.

Our tentative view is that a political desire to limit bank concentration may have played a role, early in the twentieth century, in limiting the size of British banks. Fear of bank power was prominent in British socialist thought early in the twentieth century. An important 1918 investigative committee chaired by Lord Colwyn, perhaps inspired by the 1912 Pujo investigation in the United States, produced a report on bank influence, the Colwyn Report, that urged that bank concentration be limited. No law to that effect ever passed, but large banks knew that the Bank of England would frown on and likely reject their merger proposals.¹⁷⁷ Banks stayed smaller and thus could hold less equity.

The effect of limited bank size on equity holdings was buttressed by the Bank of England's post-World War II decision not to count equity toward regulatory capital (we do not know the motives for that decision). As we discuss below, when regulatory strictures were relaxed in the late 1970s, it may no longer have made economic sense for banks to hold much equity.

We have not uncovered evidence of political concern specifically focused on the power of British insurers and mutual funds, who have never been subjected to American-style legal restrictions. The hobble-the-large-institutions political story is also weak for pension funds. Funded British pensions arose at the beginning of the twentieth

¹⁷⁶ See Roe (1993), *supra* note 28; Roe (1993), *supra* note 44; Roe (1991), *supra* note 25; Roe (1991), *supra* note 2.

¹⁷⁷ For a review of this history, see JERRY COAKLEY & LAURENCE HARRIS, *THE CITY OF CAPITAL* 171-77 (1983).

century. Large employers took the initiative in presenting new pension schemes to employees.¹⁷⁸ There was little regulation, so employers simply adapted existing trust law.¹⁷⁹ Employer motives included fending off organized labor, convincing Parliament to limit tax-funded retirement benefits, and ensuring a stable labor force (pension benefits were typically forfeited if an employee quit).

Union-controlled pension plans coexisted with company plans, but company plans won out over the long haul. Although some unions opposed company-managed plans, others saw company plans as a valuable employee benefit. Funding crises caused many union plans to shrink or disappear. Company plans had similar crises, but were usually bailed out by the corporate parent; union plans had no deep pocket to look to for help.

In sum, a direct political story for why British institutions are less powerful than their Japanese and German counterparts can be told principally for banks, and even there only in muted form. But perhaps an indirect story can be told. Fear of political retaliation could contribute to institutional passivity, and to institutional reluctance to act publicly. Prudential's chairman worried publicly in 1970 that there might be a "political reaction to any strong display of influence exercised over companies in which [Prudential had] holdings."¹⁸⁰ Writing in the mid-1980s, Farrar and Russell opined: "Institutional investors are worried about the political consequences of an exercise of power. They eschew public criticism and fear public intervention."¹⁸¹

This concern partly reflected the longstanding threat of nationalization. Many prominent industries were nationalized by Labour governments; the City was often threatened.¹⁸² As recently as 1976, the Labour Party's Executive Committee proposed nationalizing the seven largest insurers.¹⁸³ Such threats could lead large institutions to avoid publicity — even favorable publicity would call attention to

¹⁷⁸ The discussion below of the history of British pension plans draws primarily on HANNAH (1986), *supra* note 24.

¹⁷⁹ The tax benefits for pension plans came later, in 1921, when employers who had already adopted funded plans convinced Parliament to make both pension contributions and the income on the trust corpus exempt from income tax.

¹⁸⁰ PRUDENTIAL ASSURANCE CO., 1970 ANNUAL REPORT 9.

¹⁸¹ John Farrar & Mark Russell, *The Impact of Institutional Investment on Company Law*, 5 COMPANY LAW. 107, 109 (1984).

¹⁸² See, e.g., RICHARD MINNS, TAKE OVER THE CITY: THE CASE FOR PUBLIC OWNERSHIP OF FINANCIAL INSTITUTIONS (1982).

¹⁸³ COAKLEY & HARRIS (1983), *supra* note 177, at 216.

the City's influence — and cultivate corporate managers as allies rather than possible opponents.

Concern over nationalization today seems minimal. The media has strongly supported the institutions in their efforts to upgrade corporate governance standards, backed them in the Tace affair, and even criticized the Cadbury report for adopting only advisory, not mandatory, standards. Many industries have been privatized, and the Labour party has moved toward the political center to regain political viability. The alleged "short-termism" of institutional investors was a rallying cry for corporate managers during the late 1980s, but this theme has disappeared from the popular debate with a decline in the frequency of takeovers. Still, this political history could help to explain how British institutions grew up. In a path-dependent world, how they grew up could continue to influence how they behave today.

Although nationalization seems unlikely, stricter regulation remains a significant threat. Jonathan Charkham, long the Bank of England's chief adviser on corporate governance, recently worried that "to the extent that the institutions do become effective, there may be a backlash against their exercise of influence."¹⁸⁴ The institutions understand too that the Labour party might win the next election, and the party's leaders continue to refer to the City's influence in policy documents, not with approval.¹⁸⁵ When the heads of Prudential and Norwich Union boast before Parliament of their record in favoring management in a takeover bid,¹⁸⁶ they may hope to curry favor with Parliament as much as with corporate managers.

H. *Organizational Capability*

A final reason why British institutions do not intervene very often in portfolio companies involves organizational and logistical constraints on their capacity to monitor corporate managers. Even the largest insurance companies have small research staffs. For example, Norwich Union, the catalyst in the Tace affair and the manager of a £24 billion portfolio, recently expanded its staff of researchers who support its fund managers to twelve full-time persons; as of 1986, it had none.¹⁸⁷ Similarly, Prudential, which manages a portfolio more than twice as large, estimated for us that it employed around twenty full-time professional analysts, including its senior staff, to perform

¹⁸⁴ Jonathan Charkham, *The Bank and Corporate Governance: Past, Present and Future*, 33 BANK OF ENG. Q. BULL. 388, 391 (1993).

¹⁸⁵ See Davies & Stapledon (1993), *supra* note 115, at 7-9.

¹⁸⁶ See *supra* note 171 and accompanying text.

¹⁸⁷ See *Punters' progress* (1991), *supra* note 55, at 88.

research and security analysis. Yet, these insurers hold globally diversified portfolios containing hundreds of U.K. stocks and many foreign stocks as well. There is a mismatch between staffing and portfolio size — at least if one expects serious monitoring. No institutional investor that we interviewed had a professional research staff that remotely rivaled the credit analysis and workout staffs of a commercial bank of comparable size.¹⁸⁸

Staffing constraints mean that monitoring resources are usually allocated to emergency cases, often companies that are near insolvency. This, in turn, reinforces the importance of preemptive rights. For thinly staffed money management firms, the news of an impending subscription offering can signal potential trouble and alerts shareholders to take a close look at the offering firm, at the same time that the offering gives investors the leverage to force changes.

In the long run, of course, small staffs cannot explain limited oversight. We must ask why the institutions do not expand their research and security analysis staffs — as indeed some recently have.¹⁸⁹ But only a quantum leap in research capability would leave them in a position comparable to a major commercial bank. Presumably, the major insurers and pension fund managers believe that such a research and oversight capability is not economically justifiable. The unresolved question is why.

Even if they cannot greatly increase the staff effort devoted to monitoring, institutions could monitor more intensely by holding larger stakes in fewer companies, with only a trivial loss in diversification. No such trend is evident, however. This implies that British institutions either value liquidity highly or believe that the gains from more intensive monitoring are small. Several different reasons could plausibly underlie this assessment.

First, the expected value of extending oversight beyond the most troubled firms is uncertain. Investors' perception of management weakness is always tinged with uncertainty. Perhaps management is doing a competent job in difficult circumstances. Or perhaps its mistakes cannot be easily fixed. If a fatal mistake has been made, the institutions may do better to sell and cut their losses than to stay and fight — a sentiment expressed to us repeatedly by fund managers, though not by insurers.

¹⁸⁸ One explanation for the difference in bank and insurer staffing could be the number of significant investments. We lack information on the relative size of bank loan portfolios and money manager equity portfolios, but our sense is that banks are probably less, or at least no more, diversified than insurers and money managers. If so, this cannot explain why banks are more thickly staffed.

¹⁸⁹ See *Punters' progress* (1991), *supra* note 55, at 88.

Second, intervention can sometimes aggravate the problem, consuming scarce managerial time and creating unfavorable publicity. Nor is it possible to put a financial value on most intervention. In the face of such uncertainty, it may make sense to intervene only at the crisis stage, when there is more upside potential and less downside risk.

Third, in a competitive market for financial management services, a fund manager cannot charge more than its peers for its services unless it can demonstrate a better performance record. Here we come back to free riding and agency costs at the money manager level. A fund manager can outperform its rivals through corporate governance intervention only if it is overweighted in the company's stock. Even then, rivals will share in the gains. Overweighting, however, requires some sacrifice of liquidity. Institutional investors told us that they lose liquidity in smaller stocks even at a 5% ownership level. Thus, even if undervalued stocks are hard to find in a relatively efficient market, fund managers may still have an incentive to invest in a low-probability search for them because they do not need to share the gains from search, rather than to expend funds on collective action.

The free-rider problem becomes less significant as shareholder concentration increases, because it is easier to coordinate actions and prorate costs among the principal institutions. From this perspective, it is significant that British concentration levels, though higher than American levels, are substantially below those in Germany. Although German institutional investors own directly only 14% of publicly traded stock,¹⁹⁰ there are only three "universal" banks, and they vote as nominees, on average, 45% of the stock present at the shareholders' meetings in the 100 largest German corporations.¹⁹¹ Collective action is surely easier in this context. Moreover, the marginal costs of activism may be less for a German universal bank than for a British insurer because the bank already incurs monitoring costs as a creditor. In Britain, most fund managers and insurers are not significant lenders

¹⁹⁰ See Neville Nankivell, *Good governance translates into good business*, FIN. POST, Jan. 6, 1993, § 1, at 9.

¹⁹¹ See Theodor Baums, *The German Banking System and Its Impacts on Corporate Finance and Governance* 30-31 (Feb. 1993) (unpublished paper, Institut für Handel- und Wirtschaftsrecht, on file with authors). In addition, the stock voted by all banks at these meetings averaged 82.67%. *Id.* In only one case, Baums finds, did banks vote less than a majority of the shares present at the meeting. *Id.*

It should not be assumed, however, that the German pattern is optimal. Agency problems can arise when a monitor has voting power far greater than its equity ownership. For example, a German bank that owns 5% of a company's stock but votes 50% may discourage the company from taking risks, in order to protect the bank's position as a creditor, or the bank may tolerate inefficient diversification, which reduces its risk as a creditor.

to the same firms, so these economies of monitoring cannot be realized.

A further reason for limited investment in monitoring portfolio companies involves path-dependent organizational design. Any sizable institution is constrained in the things that it does well and the degree to which it can evolve by its existing infrastructure. In our interviews, we probed to find the kinds of interventions that fund managers consider feasible. When we asked if institutional investors would challenge the strategic business plans of a nonfailing company, fund managers told us in remarkably similar language: "We are stock traders, not business experts; there are limits to what we can do."

Essentially, these are limits on the firm's human capital, as shaped by the organization's history, structure, and surrounding culture. Consider merchant banks, for example. Like U.S. investment banks, they have long seen their comparative advantage to lie in trading and providing financial services. During the 1980s, trading profits grew at U.S. investment banks, with the explosion in new, complex securities and resulting arbitrage opportunities. A similar pattern, we believe, characterized U.K. merchant banks. As a result, these firms' capital moved toward trading and away from underwriting. With this change, political power within the firms also shifted to traders. Yet, traders see illiquid, long-term investments as a classic mistake. By training and harsh experience, traders know that markets fluctuate and that one must maintain liquidity and cut losses when necessary. In the trader's culture, one does not resist the market's judgment over even the medium term in the hopes of securing ultimate vindication. In short, relational investing and the trader's culture are fundamentally in tension.

The point here goes beyond the cautionary working rules by which merchant banks have grown and prospered. The merchant bank's human capital is focused on trading. The merchant bank develops expertise in predicting the future value of a corporation's securities, but much of that expertise is focused on the near term. The merchant bank need not simultaneously develop the capacity or inclination to intervene and restructure the corporation, save perhaps in extreme cases.

An argument about the limited human capital of money management firms takes one only so far. If the profits were attractive enough, these firms could acquire the human capital needed to rehabilitate mismanaged companies. But organizational change is difficult and risky. The new venture may fail; even worse, the effort may dilute the firm's expertise in its current business. Nor is it clear

that insurers or merchant banks should redeploy their human capital in this way. There are no role models to convince merchant banks that they can earn above-market returns through activist, long-term investing.

The U.S. experience with leveraged buyouts is relevant in this regard. During the 1980s, leveraged buyout firms evolved in the United States — most prominently, Kohlberg, Kravis, Roberts & Co. (KKR) and Forstmann Little & Co. — and undertook to restructure diversified firms. Initially, U.S. investment banks firms advised and financed the leveraged buyout firms but did not compete directly with them. Only when they saw that enormous returns were possible did the largest firms — Merrill Lynch, First Boston, and Shearson Lehman — enter the field as buyout competitors. Similarly, British merchant banks seem likely to become relational investors and undertake to restructure faltering British companies only if some new entrant first demonstrates that large profits are attainable. As one fund manager told us, "Until you see that it works, you don't invest in a theory."

Moreover, such a move, even if attempted, could well fail because the imitators lack the institutional capabilities of the first movers. Leveraged buyouts again offer an instructive example: leveraged acquisitions gone sour helped to drive Drexel Burnham into bankruptcy and forced First Boston to turn to its then-40% shareholder, Credit Suisse, for a bailout.¹⁹²

Failing such a development, institutional activism in the United Kingdom, we believe, will continue to be triggered primarily by clear managerial failure, though management's margin for error may diminish. The voices of institutional investors may help to establish new corporate governance norms, like majority independent boards, and to persuade laggard managers to accept the new norms. But frequent proactive monitoring remains unlikely. Instead, the dialogue between investors will remain a game of bluff and counterbluff, as institutions threaten to take steps that both sides know are costly to them.¹⁹³

¹⁹² See Steven Greenhouse, *Reviving a Humbled First Boston*, N.Y. TIMES, Mar. 11, 1991, at D1; Stephen Labaton, *The Collapse of Drexel Burnham Lambert*, N.Y. TIMES, Feb. 14, 1990, at D4; see also Bill Jamieson & Margareta Pagano, *Gateway losing grocery battle*, SUNDAY TELEGRAPH, May 17, 1992, at 33 (describing Wasserstein Perella's disastrous acquisition of a large stake in Gateway).

¹⁹³ Others have disagreed with our conclusion that the relationship between investors and managers will not change radically in the near future. Samuel Graves and Sandra Waddock argue that institutional investors, and pension funds in particular, could become the "conglomerate of the 1990s," paralleling the role of the main bank in the Japanese keiretsu. Samuel B. Graves &

I. *Are Banks Unique?*

Although we have developed reasons why insurers and money managers, which are the major equity holders in Britain, are thinly staffed and likely to remain so, this begs two critical questions: Why are banks more thickly staffed? And why do British banks, who could combine their natural lending role with an equity stake and thereby achieve monitoring synergies, hold so little equity?

1. *Why Do Banks Invest in Monitoring?*

Banks in Britain and other countries spend substantial resources to monitor their loan portfolios. One plausible reason relates to liquidity. Bank loans, especially troubled loans, are much less liquid than corporate equities. Lacking the ability to sell and cut their losses, banks may be forced to invest heavily in monitoring and, equally important, in organizational structures that are conducive to monitoring.

Closely tied to illiquidity is informational asymmetry. Lack of information about bank loans, especially the absence of a consensus price, not only makes sale difficult, it also forces the seller to accept a large discount on sale, to protect the buyer against the risk that the seller will unload "problem" loans when the sale price exceeds the loan's value. This is a classic "lemons" problem, in which high quality loans cannot be sold for a fair price. The gap between potential sale price and actual value reduces the incentive to sell and leaves more room for banks to add value through monitoring. It is no accident that every major bank has a sizable workout department.

Third, the agent bank typically holds a substantial fraction of the total loan for its own account. Even if the loan is largely syndicated, the agent bank's reputation, and thus its ability to syndicate future loans, depends on its monitoring success. Thus, both agency costs at the investor level and collective action effects are reduced. Again, the effect is to justify more monitoring.

Sandra A. Waddock, *Ownership at a Distance: Implications of Activist Institutional Investors*, BUS. CONTEMP. WORLD, Spring 1990, at 83. Such a prediction, however, fails to "unpack" the pension fund and see it as a pool of financial assets, nominally administered by trustees but actually run by money managers located in merchant banks and insurers. Once the focus is shifted to professional money managers, those managers' incentives to engage in collective action are weaker, their conflicts of interest are stronger, and, as discussed in the next section, their ability to acquire the monitoring capacity of a commercial bank is questionable.

We are not alone in speculating that other institutions, who are more natural equity holders, may be intrinsically weaker monitors. R.E. Artus of Prudential has written:

My guess is that any conceivable increase in [shareholder] activity will not . . . match[] that of the bank-based economies, since share ownership unaccompanied by the additional involvement in providing finance and other services will never provide the depth of knowledge and commitment that arises with the combination of banking and proprietary interests.¹⁹⁴

2. *Why Don't British Banks Hold More Equities?*

British banks hold little equity. They voluntarily forgo the monitoring synergies that would arise if they held both debt and equity in the same firm: holding both equity and debt increases influence; the gains from oversight flow to both sets of holdings; and substantial monitoring is already justified on the loan side.

One possible reason is that, like banks in many industrialized economies, British banks combine thin equity — equity capital equal to a small percentage of total assets — with a timing mismatch between their assets and liabilities. That is, their assets, which are chiefly loans, are illiquid, while most of their liabilities are short-term deposits, often due on demand.¹⁹⁵ Hence banks and their regulators have to worry about "runs" — sudden mutually reinforcing decisions by depositors to withdraw their funds.

A bank that holds large blocks of stock aggravates the timing mismatch between its assets and liabilities by exposing itself to the greater volatility of common stock. For example, assume that a British commercial bank held 20% of its assets in stocks and had net worth equal to 4% of its assets. In October 1987, when stocks declined over 20% in one day in most major securities markets, such a bank would have been rendered technically insolvent. Its total assets, valued at market, would have fallen below its total liabilities. Even without regulation, rational bank executives recognize this danger and confine stock investments to a modest portion of the bank's portfolio. Moreover, bear markets for stocks tend to correlate with an increase in troubled loans — the bank gains little diversification by holding this asset class.

Even so, British banks seem to display an overabundance of caution. Their investments in equity securities today amount to under

¹⁹⁴ Artus (1990), *supra* note 11, at 14.

¹⁹⁵ See Coffee (1991), *supra* note 3, at 1318-21.

1% of their assets. This level has not risen since regulatory restrictions were lifted in the 1970s.¹⁹⁶ Indeed, as a historical matter, the major London banks have never played a significant role — as shareholders or as lenders — in major British corporations.¹⁹⁷

German and Japanese banks have overcome the thin equity hurdle. Why the difference? One possible explanation takes us back to the political story and the likely importance of path dependence. Banks are natural monitors because they must already monitor their loans. But they can hold large, risky stock positions only if they have a large equity base as a percentage of assets. If German and Japanese banks — in part because of government encouragement¹⁹⁸ — became large stockholders early on and built their equity base as their stockholdings grew in value, this situation could be stable for a substantial period of time. Then, with the introduction of deposit insurance later in this century in both Germany and Great Britain, banks probably found it cheaper to raise capital from depositors than from equity shareholders.¹⁹⁹ In any event, after the appearance of deposit insurance, bank depositors in both countries had less incentive to demand that their banks maintain a substantial equity capital to support their debt claims. As a result, the initial disparity between the equity base of German banks and that of British banks may have become locked in, as thin equity became a permanent characteristic of British institutions seeking to raise capital at the lowest cost. In addition, monitoring synergies are probably smaller today than in the past because large companies are increasingly able to borrow in the

¹⁹⁶ See *supra* Table 1.

¹⁹⁷ See SCOTT (1986), *supra* note 101, at 2. Scott notes that local "country" banks outside the metropolitan centers of Great Britain financed the infant companies that began the Industrial Revolution. *Id.*

¹⁹⁸ The evidence on the close involvement of German governmental and political forces in the growth of Germany's universal banks is well known. See, e.g., RICHARD TILLY, *FINANCIAL INSTITUTIONS AND INDUSTRIALIZATION IN THE RHINELAND 1815-1870* (1966); Richard H. Tilly, *German Banking, 1850-1914: Developmental Assistance for the Strong*, 15 J. EUR. ECON. HIST. 113 (1986).

¹⁹⁹ Deposit insurance arrived relatively late in both Germany and Great Britain. In Germany, although the historical roots of deposit insurance date back to the 1930s, deposit insurance was not extended to the large commercial banks before the late 1950s and early 1960s. Initially, deposits were insured only up to a relatively low level (DM 10,000). Following the collapse of the Herstatt Bank in 1974, Germany's private banks (which category includes its universal banks) established a Deposit Protection Fund with greatly increased coverage that today insures virtually 100% of all deposits. See MARIA L. FRES-FELIX, *DEPOSIT INSURANCE SCHEMES* 31-37 (1991). In Great Britain, deposit insurance is today mandatory with the creation of the Deposit Protection Fund in 1982. The Fund is administered by the Bank of England and covers 75% of deposits of up to £20,000 (effectively the Fund covers a maximum of £15,000). As in Germany, the creation of this Fund was a response to banking failures in the 1970s. *Id.* at 39-40.

public debt markets more cheaply than from banks.

From this perspective, there may have been a brief window period early in this century when banks having a large equity base could have exploited their position as joint holders of debt and equity. Today, that moment seems to have passed, and the incremental value from holding long-term equity stakes and engaging in active monitoring would not justify building a costly equity base. More recently, as public debt financing for corporations became more widely available, British banks lost the potential monitoring synergy from holding both debt and equity. Moreover, in Britain, insurers were already large equity holders and moderately active monitors. The insurers may already be capturing the easy gains from monitoring. The question for banks is then whether the remaining gains from more intense monitoring justify building large equity holdings and taking the accompanying risk. They apparently think not.

A second explanation for the larger equity holdings of Japanese and German banks begins with the much closer relationship between the major banks and the central government in both countries. Germany has only three universal banks, which are too big for the government to let fail. Being smaller, British banks are less assured of a government bailout if the equity market sours and thus can take less equity risk. In Japan, the risk of equity investments for banks is limited both by an implicit government guarantee against bank failure and by the alleged willingness of other members of the bank's industrial group (keiretsu) to support the stock market prices of their main bank and of the principal keiretsu members.²⁰⁰ Indeed, the stock of most Japanese banks is held principally by others in the same keiretsu, or other firms that the bank lends to, leaving only a small public float.²⁰¹ In such an environment, the willingness of Japanese banks to hold large equity stakes could, in part, reflect keiretsu members' ability to stabilize the market prices of keiretsu members. Thus, Japanese banks may face a smaller risk of sudden stock price declines than a Western bank making similarly large equity investments.

²⁰⁰ See Marshall Auerback, *Japan Inc.'s Days Are Numbered*, WALL ST. J., Sept. 3, 1991, at A18.

²⁰¹ At the end of 1989, the free float in most Japanese bank stocks was as low as 8% of the outstanding shares. This lets keiretsu members support the market price of their main bank's stock through relatively small additional purchases. *Id.* With the more recent decline in Japanese stock prices, this reciprocal system of price support has come under increasing strain, and it will be instructive to see if Japanese banks reduce either the size of their equity stakes or their total stock investments.

The organizational change that would be needed for British commercial banks to become serious equity investors may also dissuade them. The required transformation seems easily as great as that which trading-oriented merchant banks would have to undergo to become long-term investors. Perhaps too, there are gains to holding large stakes with corresponding influence, but only small gains to holding smaller, less influential 1%-3% stakes. In such a world, banks with puny equity holdings will see much risk and little gain from increasing these holdings.

Pulling these pieces together, we believe that it is probably too late for British banks to become large equity holders. Perhaps the opportunity would have existed in the past, in a more inviting regulatory climate or perhaps banks will become large equity holders only with an affirmative regulatory shove, as was apparently the case in Japan and Germany.²⁰² On this we can only speculate. But for British banks, the window of opportunity, if it was ever open, now seems firmly shut and unlikely to open again.

VI. IMPLICATIONS: WHAT THE BRITISH EXPERIENCE MEANS FOR THE UNITED STATES

The heavily institutionalized British securities market may offer a preview of what American securities markets will look like in a decade or so. What then does current British experience predict for the United States? To address this question, one needs to break it down into several component parts:

(1) What level of coordinated activity among institutional investors appears likely in the United States if the level of institutional ownership continues to rise?

(2) If Glass-Steagall and similar legislation were repealed or relaxed, would American banks become large equity holders and active monitors, like the German "universal" banks or the Japanese "main" banks?

(3) To what degree is institutional investor behavior path dependent — shaped and constrained as much by the limited mutability of existing organizations as by external factors, such as regulation?

(4) If American banks and insurers remain largely passive, can American mutual funds or pension funds fill the corporate governance role played by Japanese and German banks and by British insurers?

²⁰² See Roe (1993), *supra* note 7, at 1955-56, 1971-72; TILLY (1966), *supra* note 198; Tilly (1986), *supra* note 198.

(5) What changes in U.S. regulation would prompt American institutions, taken as a whole, to act as British institutions now do?

(6) What can the British experience tell us about the desirability of those regulatory changes?

A. How Will Institutional Cooperation Evolve in the United States?

\ An initial question is whether the United States, if it approaches British levels of institutional ownership, will also approach British levels of institutional activism. The probable answer is no. Several factors seem likely to dampen U.S. oversight relative to British oversight.

First, U.S. institutions are unlikely to approach the level of concentration or the geographic and cultural cohesion of the City, where contact among institutional investors is constant. Lower concentration means that coalitions of U.S. institutional investors will have to have more members to aggregate the same percentage of stock. Yet the British experience suggests that keeping group size to a minimum is important in reducing coordination costs. Moreover, for a given level of ownership concentration, the City's geographic and cultural cohesion reduces coordination costs. Thus, coordination costs seem likely to remain lower in Britain than in the United States.

Second, the British experience highlights the importance of fund managers' incentives. British institutions look to those who are overweighted in a stock to organize a shareholder coalition. It has often been claimed that as institutional investors hold larger stakes in corporations, they will naturally become more active investors.²⁰³ The British experience, however, suggests that fund managers focus more on relative performance than absolute performance. American institutions, like their British counterparts, may be less willing to join coalitions or to take collective action because their success will benefit others as much or more as themselves. In short, a large stakeholder will not necessarily be an active investor, even apart from conflicts of interest or regulatory constraints.

Third, British institutions' leverage over corporate managements is in considerable measure the product of their ability to collectively decline to participate in a subscription offering. This market weapon

²⁰³ See, e.g., Black (1990), *supra* note 2, at 575 - 84 (developing a model in which shareholder activism increases with the size of shareholdings).

has strong advantages over the proxy contest, which requires money managers to bear large direct and indirect costs. American institutions lack a comparable weapon. Preemptive rights are optional under most state corporate statutes and are rarely found among large U.S. firms. Moreover, the effectiveness of refusal to subscribe as a shareholder strategy increases with concentration of shareholdings and requires mutual trust among the large institutions that a promise not to subscribe will be honored, despite the short-term gains from subscribing or selling one's rights.

Fourth, as we discuss in section VI.C, it seems unlikely that U.S. banks or insurers will quickly become active shareholders even if the remaining regulatory barriers disappeared tomorrow. There is reason to doubt whether American mutual funds or pension funds will be willing, or can easily develop the institutional capability, to serve the role that British insurers now play.

Fifth, important regulatory differences exist between the two countries. In particular, U.S. law forbids institutions from acting jointly in the quiet, behind-the-scenes fashion that is typical in Britain.²⁰⁴ Thus far, American institutions are mostly unwilling to make the public Schedule 13D filing that must accompany any voting or cost-sharing agreement among shareholders holding 5% or more of a company's stock.²⁰⁵ Still, because these rules are deeply intertwined with the American preference for sunlight and market transparency, only limited relaxations of them seem likely. Moreover, American-style litigiousness has not yet penetrated the British corporate landscape. A British institution's effort to change management is unlikely to involve heavy legal bills.

B. Can Regulation Explain Bank and Insurer Behavior?

The British example sheds light on a central question: What role does legal regulation play in fostering the passivity of American banks and insurers? In the United States, bank and insurance regulation discourages or prohibits significant stock ownership; in Britain, these regulatory obstacles are absent. If a web of regulation has pacified American banks and insurers, as the political model of American corporate governance predicts, then similar but less

²⁰⁴ See generally *id.* (describing securities law constraints on American financial institutions).

²⁰⁵ See, e.g., Robert Pozen, *Institutional Investors: The Reluctant Activists*, HARV. BUS. REV., Jan.-Feb. 1994, at 140, 145 (Pozen, a managing director of Fidelity Investments, advises that: "At the end of [a conversation on a voting proposal], both parties should state clearly that they will not be voting together or buying or selling securities together.").

regulated British institutions should be active investors, holding large stakes and perhaps paralleling the activities of large Japanese and German banks. Conversely, if regulatory controls do not explain investor behavior, one might expect British investors to behave much like their American brethren.

The British evidence fits neither pattern well. British institutions are more active than their American counterparts. Regulatory differences may explain some of this difference. However, regulation cannot explain the very different behavior of different classes of British institutions. British insurance companies have traditionally been the most active investors in the United Kingdom, but British banks hold almost no British equities. Why the difference?

We have already explored the possible reasons why British banks did not become large shareholders. Insurers are potentially subject to similar problems, but British insurers are substantial equity investors. A closer look at British insurers shows how they have avoided the thin equity problem of the banks. First, insurance company creditors — that is, policyholders — can be locked into their investments, through sales loads, up-front commissions, and liquidation penalties, to a greater degree than bank depositors. Thus, the risk of a sudden massive withdrawal of funds is reduced.²⁰⁶ More importantly, British insurance companies developed techniques by which to pass equity risk to their policyholders. British insurers first began to invest heavily in equities during the 1930s.²⁰⁷ This movement was led by the mutual insurers, whose policyholders, who were also in effect their shareholders, bore the equity risk.²⁰⁸ In time, the joint-stock insurers copied the mutuals' success by designing financial products with variable returns based on market performance.

Since the mid-nineteenth century, life insurance has been a popular form of retirement savings in Britain, particularly among the working class.²⁰⁹ With the explosive growth in retirement savings

²⁰⁶ Although runs on insurance companies are rare, they do occur. See, e.g., *Best's Insolvency Study: Life/Health Insurers 1976-1991*, BEST'S REV., June 1992, at 18, 130 (stating that policyholder runs precipitated the collapse of Executive Life and Mutual Benefit Life in 1991).

²⁰⁷ SCOTT (1986), *supra* note 101, at 88 - 89.

²⁰⁸ As of 1951, some mutual insurers had 30% of their assets invested in stocks, while joint-stock insurers had only 10% of their assets similarly invested. *Id.* at 89. This suggests that market-volatility risk inhibited stock ownership, a factor that would apply even more strongly to banks.

²⁰⁹ *Id.*

after World War II,²¹⁰ U.K. life insurers were flush with cash and increased their stakes in British corporations. By the mid-1950s, Prudential, for example, held 5% or larger stakes in a number of the largest British corporations.²¹¹

Banks, in contrast, were not the natural repository for individuals' long-term retirement savings. Perhaps as a result, they have never designed financial products that pass along or share the equity risk of stock investments with their depositors. Yet, for at least the last fifteen years, there has been no regulatory barrier to banks' developing such products. The obvious explanation is one of industry specialization: insurers provide these products, and banks have no comparative advantage.²¹²

To understand the British mix of activism and passivity, it is not enough to explain why British insurers hold stock and British banks do not. We must also seek to understand why the large British insurers — notably Prudential, Norwich Union, and Legal & General — are among the most activist U.K. institutions, while many pension fund managers with portfolios of similar size are less active. The insurers appear to be less constrained by the costs of activism that loomed large for many of the fund managers that we interviewed. Here, it may be important that insurance companies are "true" owners of a substantial portion of their portfolios.

A hypothesis: Institutions, like British insurers, who both own substantial equity stakes for their own account and manage funds for others, will more readily conclude that expenditures on corporate governance are in the interests of those whom they serve as fiduciaries than will institutions who invest almost exclusively on behalf of others. It is, after all, a conclusion that meshes with their own self-interest, because it allows them to spread costs among others receiving benefits. In this, British insurers look at least somewhat similar to German universal banks, who own significant equity stakes and hold and vote even greater equity investments as fiduciaries for individual customers. At the same time, the historical evolution and comparative freedom from regulation of British insurers may explain why they hold more stock for their own account and are much more active than American insurers.

²¹⁰ See Davies (1994), *supra* note 8, at 258-61.

²¹¹ SCOTT (1986), *supra* note 101, at 89-90.

²¹² In the United States, life insurance annuities receive favorable tax treatment that is not available to banks offering similar products. See I.R.C. §§ 805, 808, 815 (1988). We do not know whether British tax law similarly favors insurers.

C. Path Dependence

Path dependence in the evolution of financial institutions, we have suggested, is important in understanding why British banks own almost no stock and play a trivial role in British corporate governance, in sharp contrast to German and Japanese banks. Path dependence will likely also be critical in shaping the future course of American corporate governance, even if legal barriers to shareholder action are reduced. In the United States, as in Britain, the time when banks were major lenders to large corporations has passed. In the United States, as in Britain, other institutions have filled, at least in part, the corporate governance vacuum left by the banks' absence. In the United States, as in Britain, the dominant source of the funds that financial institutions manage is retirement savings, primarily through pension plans. Finally, in the United States, even more than in Great Britain, the existence of mandatory deposit insurance is likely to reduce any interest U.S. banks might have in developing the equity-capital base necessary to support substantial equity investments.

In the United States, as in Britain, then, financial institution involvement in corporate governance is likely to involve a small role for commercial banks and a large role for the institutions that manage retirement savings — corporate pension plans, public pension plans, and outside money managers for these plans. But over the long term, the dominant players are difficult to discern. Today, pension funds loom large. Public and private pensions together hold around 30% of all U.S. equities and around 60% of all equities held by financial institutions. Public pension plans are vocal, while corporate pension plans are mostly passive — partly because they are controlled by corporate managers. For reasons unrelated to corporate governance, defined contribution and 401(k) plans have grown rapidly, partly at the expense of defined benefit pension plans. Defined contribution and 401(k) plan growth, in turn, has helped to fuel the growth of the major mutual fund complexes that are the natural repositories for investment of employee-directed pension assets. It is possible that mutual fund groups, through a combination of individual accounts and corporate-derived pension accounts, will have the size to play at least a coequal role with public pension plans in American corporate governance twenty years hence — if they choose to.

American insurers seem unlikely to approach the role played by British insurers. Direct regulatory limits on insurers holding stock have largely disappeared, but net capital rules still limit insurers' shareholdings. Perhaps more importantly, a high-cost sales apparatus,

developed to sell individual life insurance policies, impedes the insurers' effort to capture individual retirement assets. The cost of an army of insurance agents drags down the returns on variable annuities, compared to competing mutual funds, while the tax deferral benefits available through 401(k) plans substantially offset the deferral offered by life insurance policies.

Path dependence may help to explain the uphill battle that American insurers now face in competing with mutual funds and private pension managers. When British insurers, beginning in the 1930s, were developing variable annuities and reaping the advantages that accrue to the first mover in collecting household retirement funds, American insurers could not hold stock. They developed a sales structure and institutional expertise appropriate to the fixed-payoff products they could sell. By the time the insurers could become major equity players, pension fund managers and mutual funds had captured the lion's share of the variable-payoff market.

If we are unsure which American financial institutions will be the most significant, we can be even less confident in predicting how they might behave in a less-regulated environment. Mutual funds, for example, began as trading and stock-picking institutions. Mutual fund *groups* arose later, because of economies of scale in servicing large numbers of individual accounts and economies of scope in one-stop shopping for different types of mutual funds. Today, the major fund groups combine centralized account administration and marketing with decentralized stock-picking. One Fidelity fund might be buying the same stock that two others are selling. With rare exceptions, the individual funds within a group are too small to have much influence on the companies they invest in.

Mutual fund influence must flow primarily from the *aggregated* holdings of the multiple funds in an affiliated group. But most mutual funds today lack that level of coordination. Will the potential profits from monitoring, shared across the funds in a fund group, justify the organizational innovation needed to capture these profits? For corporate governance initiatives, the profit opportunity is subtle, hard to quantify, shared with one's competitors, and impeded by regulatory barriers. Under those circumstances, mutual fund groups, whose institutional structure developed when oversight of corporate managers was not a realistic possibility, could fail to adapt to this new business opportunity, even if the opportunity is real. Moreover, because mutual funds invest strictly as agents, and not for their own account, their strong concern with relative performance could dampen

their incentive to invest on oversight, much as concern with relative performance explains the passivity of underweighted British institutions. We will simply have to wait and see.

D. *International Convergence*

One finds recurring hints, in the British experience, that we may be in the early stages of an international convergence in institutional behavior. Capital flows and financial institutions are increasingly international in scope. As financial institutions expand their international presence, they are increasingly exposed both to different expectations as to how they will act and to competition from other institutions with different histories.

For example, vocal shareholder activism, American style, is both being brought to other countries by American institutions and piquing interest among foreign institutions.²¹³ We have already discussed the efforts by Fidelity Investments at Brown & Jackson and WPP. Conversely, Japanese- or German-style long-term relational investing, and British-style informal discussions with management, are piquing American interest.

As U.S. institutions buy *and vote* more foreign shares, they appear to be inducing change in the traditional British practice of not bothering to vote. British institutions are finding that if they do not vote, foreign-held shares will carry disproportionate weight in the final tally. Institutions accustomed to voting are complaining about the weighted-voting schemes that are common in Europe, though it is too early to tell how effective such complaints will be.²¹⁴

Regulatory convergence is chancier than cultural convergence because it will be mediated by local politics, but some convergence is already occurring. Examples include the worldwide net capital rules for commercial banks adopted by the Bank for International Settlements; British adoption of elements of the strong disclosure rules that have long been a part of U.S. securities regulation; and the Cadbury Committee recommendation, patterned on U.S. and Canadian

²¹³ See, e.g., Cohen (1993), *supra* note 125, at 12; Melcher & Oster (1993), *supra* note 41; Roger Miles, *Stirrings of Activism in the U.K.*, GEORGESON REP. (Georgeson & Co., New York, N.Y.), Summer 1993, at 5.

²¹⁴ See, e.g., Richard C. Morais, *Such self-importance*, FORBES, Apr. 12, 1993, at 44.

practice, that public firms have audit committees composed exclusively of outside directors.²¹⁵

E. Is British-Style Intervention Desirable?

We have suggested above that the United States will not easily achieve even the British level of oversight of corporate managers by major financial institutions. But the United States has moved in that direction through proxy reform, and could surely move further through additional legal reform. What insight does the British experience shed on the desirability of that reform?

On the whole, from an American perspective, the British corporate governance model seems moderately attractive. The procedural and structural steps that British institutional shareholders have taken, such as discouraging dual-class voting structures, preserving preemptive rights, and pressing for separation of the posts of chairman and chief executive, seem sensible. Crisis-driven, company-specific intervention is unlikely to cause harm to already well-run companies. Thus, concerns that financial institutions will meddle in ordinary business decisions seem ill-founded. The institutions have neither the time nor, as they are quick to point out, the expertise. Even in a crisis, British institutions are reluctant to boot out the old managers until they have found a promising successor.

Moreover, this intervention seems directed at a class of firms whose problems are not effectively addressed by takeovers. Although replacing inefficient management is an important motive in at least some takeovers,²¹⁶ seriously troubled firms tend not to become targets, at least in Britain.²¹⁷ Perhaps, uncertainty about just how bad these firms' problems are and whether an outsider can fix them is too great for a raider to make a hostile bid.

To be sure, British industry, taken as a whole, is not usually held out as a shining example of economic success. But that may merely show that other factors matter more than corporate governance in determining a country's overall economic success. We can still learn from the British in the corporate governance area — where they have apparently had moderate success with a system not so different from ours.

²¹⁵ See CADBURY COMMITTEE REPORT, *supra* note 61, ¶¶ 4.33 - 4.38 & app. 4 (discussing U.S. and Canadian audit committee rules and experience).

²¹⁶ See GILSON & BLACK (1993), *supra* note 135 ch. 10.

²¹⁷ See Julian Franks & Colin Mayer, *Hostile Takeovers in the UK and the Correction of Managerial Failure* (Apr. 1993) (unpublished discussion paper, London Business School and University of Warwick, on file with authors).

VII. CONCLUSION: THE HALF-FULL GLASS

U.K. institutions are more involved in corporate governance than their U.S. counterparts. This is one central conclusion from our research. But institutional activity in the United Kingdom is still constrained by the costs associated with forming and maintaining shareholder coalitions and the limited incentives of money managers to invest in monitoring. Thus, the British experience suggests two lessons for the United States: (i) Reduce regulatory controls and institutional investors will become more active; and (ii) reduce regulatory controls and other constraints will surface that preclude radical change. One can debate, we suppose, whether the glass of water is half full or half empty. We are content with observing that, when regulatory inhibitions are relaxed, the glass is neither full nor empty.

Moreover, the conventional wisdom that institutional investors in the British market-centered system are significantly less involved in corporate governance than major banks in bank-centered systems like Japan and Germany may not be accurate. Oversight *could* plausibly be more thorough in bank-centered systems, because the banks have a larger investment and can realize economies of scale in their dual role as both an equity and a debt monitor. But Japanese and German banks, like British financial institutions, are slow to intervene unless a client corporation is in serious trouble. Conflicts of interest and mutual back-scratching can also constrain monitoring within the bank-centered systems. How different the level of actual oversight is between bank-centered and market-centered systems remains uncertain.²¹⁸

We may be discovering, in the British experience, a different kind of inherent limit on shareholder monitoring of management — not the complete passivity announced by Berle and Means and based on the separation of ownership and control, but rather the reluctance of even large shareholders to intervene, based on imperfect information, limited institutional capabilities, substantial coordination costs, the misaligned incentives of money managers, a preference for liquidity, and the uncertain benefits of intervention. Agency costs at the fund-manager level may be no less important than at the corporate-manager level, with the fund manager focused more on performance relative to its rivals than on absolute performance. Coordination costs persist even when financial intermediaries aggregate large blocks of stock so as to possess the "clout" that the Berle-Means shareholder lacks.

²¹⁸ Cf. J. Mark Ramseyer, *Columbian Cartel Launches Bid for Japanese Firms*, 102 YALE L.J. 2005, 2010 -11 (1993) (questioning whether "Japanese main banks do significantly more [monitoring] than other banks elsewhere").

As a result, shareholder oversight of corporate managers will always be a matter of more or less and will need supplementation by other constraints. Installing a strong board is, no doubt, a central shareholder task, but it is no panacea: the most able directors often have other full-time jobs; corporate officers control the information that flows to the board; small-group dynamics and consensus decisionmaking inhibit fast action. Agency theorists might say: We could have told you so.

How much shareholder oversight, and what kind of oversight, would occur in a less-regulated U.S. market? We see no determinate answers to this question. Instead, the evolution of a corporate governance system, within any given set of legal constraints, is likely overdetermined. At the same time, the multiple constraints on oversight give us confidence that deregulation to permit American institutions to act more like their British counterparts will not unleash massive, misguided institutional meddling in corporate affairs. Quite the opposite — the British are far more concerned with getting their large institutions to pay attention to corporate governance than with stopping them from intervening too much. Moreover, there are severe constraints on the mutability of financial institutions. What U.S. financial institutions can do depends on what they have done, or not done, in the past. In all likelihood, U.S. institutions will remain less active than their British counterparts for some time to come.