Institutional Ownership and Governance

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Abstract

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Keywords: shareholder activism, institutional ownership, governance, institutional activism

JEL Classifications: G2, G3

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Institutional ownership and governance

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I. Introduction

Everyone agrees that ownership matters in our public and private capital markets. The more debatable question is: does one form of ownership perform better than another? And, should regulatory authorities remain neutral or be biased in favour of one form of ownership over another? For example, the ownership of UK listed companies is highly fragmented, with very few controlling shareholders, particularly families. As a result, the stock market is dominated by institutional shareholders with only small stakes. In contrast, in Germany and Italy family-controlled companies make up one-third or more of the listed capital market. Moreover, in most other stock markets around the world, controlling shareholders are the rule not the exception. The difference in ownership has a profound impact on how the companies are governed and their performance. This paper focuses on how different investors engage with companies they have stakes in, particularly institutional investors, and how these engagements might influence the performance of the company. The final section examines potential regulatory responses that might improve governance and the evolution of ownership.

These issues have become more important in recent years, because of changes in the landscape of ownership and how companies have been governed. First, there has been a dramatic decline in the number of domestic listed companies in some major stock markets. There has been a fall in the UK's main market from almost 2,200 listed companies in 1999 to 935 in 2019, and in the US from more than 7,500 in 1997 to about 3,600 in 2016.[1] Jensen predicted this (partial) 'eclipse of the public corporation' and attributed it to the failure of governance by owners who often held tiny stakes in companies, managed by collective funds such as pension funds, insurance companies, and mutual

[1] This net decrease reflects both a large number of delistings, owing to companies being taken private, and low levels of new listings. See Economides *et al.* (2016).

funds. The fragmented ownership of these collective funds, often holding on average no more than 3 per cent in a company's stock, created problems of both free riding and agency costs. The absence of a controlling shareholder and the separation of ownership and control has led to what Mark Roe has described as 'strong managers, weak owners'.[2]

The contraction in the number of listed companies has reflected a decline in both new listings and delistings due to mergers and 'going private'. For example, in the UK, new listings were around 160 in 2000, falling to 40 in 2016; and, in the first nine months of 2019 there were only 16 new issues. Equally important, delistings increased owing to merger activity and private equity transactions. Delistings exceeded new listings in every year from 1998 to 2014. The decline in new listings reflected developments in capital raising, both in the public and private capital markets. The demand for new equity financing has diminished. Listed corporations, far from needing access to the public markets to raise new equity, engaged in large-scale repurchases of their own equity. Annual repurchases, as a proportion of market capitalization, averaged 2.9 per cent in the US over the 5 years, 2014–18. Moreover, younger private companies requiring new equity capital have been able to raise capital in the private markets in ways that previously were only available in the public markets.[3] The growth of non-bank intermediaries, the rise of (large) private equity funds, and the willingness of institutions like pension funds and insurance companies to fund private companies, have all conspired to enhance private markets at the expense of public markets.

The advantages of private markets were not only in the availability of capital. In the buyout of Blackberry by a private equity firm, Mr Watsa of Fairfax Financial said 'Blackberry will be best served by repairing its business away from the public markets.' The founder of Dell Computers justified going private when he said, 'I believe we are better served with partners who will provide long term support to help Dell innovate and accelerate the company's transformation strategy.' In both cases the impression given by owners was that stock markets were myopic and private capital markets were more patient and long-termist. More recently in 2019, WeWork cancelled its initial public offering (IPO) over concerns by the public markets about its governance and inflated expectations of the private markets.

There have also been significant changes in the asset management industry which have had implications for the governance of listed companies. There has been a large growth in passive or index funds at the expense of active funds. In the US, index funds have recently reached parity with active funds in terms of size of funds under management. An important difference between the two is that index funds purchase a basket of securities that mirrors an index such as the S& P 500. Changes to the index fund are largely determined mechanically by changes in the relative size of market capitalization, not by stock picking, as with active funds. Thus, while active funds can threaten exit with companies that refuse to rectify their governance failures, an index fund cannot exit from a failed engagement. In effect, active funds can use 'voice and exit' while passive funds can use 'voice' only.

It is an important question whether the inability to exit would increase or reduce their incentive to invest in governance. It might be argued that index funds would invest less in governance because they cannot trade on the information they generate from monitoring and engaging with companies.

[2] See Jensen (1989) and Roe (1994). See also 'London stock market is ailing but it deserves to be resuscitated', *Financial Times*, 19 September 2019, p. 14.
[3] See Ewens and Farre-Mensa (2018) and Doidge *et al*. (2018).

In a comparison of two large asset managers referred to below, we find that the active manager employs a governance team where each member handles engagements with fewer than 20 companies on average, in contrast to the 200 or more handled by each team member of the index fund. The consequence is that the active manager seems to invest much more in governance than the passive fund. This may also have something to do with the business model of index funds which charge much lower fees than active asset managers.

Not all the changes in recent years favour the private capital markets. The rise of shareholder activism led by large activist hedge funds, such as Elliott Partners in the US and Cevian Capital in Europe, may be viewed as a response to the market failures of the public markets. Shareholder activism provides an alternative to private equity which takes a company away from the public capital markets. Activists take significant minority stakes in under-performing listed companies, often attributing their under-performance to failures of strategy. While the stakes they purchase average less than 10 per cent, they often have to attract other asset managers to their cause, particularly when management of the target is hostile to their objectives. When the activist calls an extraordinary general meeting or a proxy vote to remove management, they will need to attract the votes of other shareholders. In other words, the hedge fund activist will have to convince other shareholders to support their cause. In May 2018, Elliott Partners, a large US activist investor with a stake of 8.8 per cent in Telecom Italia, sought to replace the board of directors and required a majority of investors to vote against management at a shareholders meeting.

Shareholder activism has come to be seen as the new market for corporate control, where activist engagements are largely motivated by correcting managerial failure. Previously the market for corporate control was associated with hostile takeovers.[4] Seen in this light, activist engagements are almost four times more frequent than hostile takeovers in the US, eight time more frequent in Italy, and one and half times more in the UK (Becht *et al*., 2017). Numerous studies of takeovers are inconclusive about whether they are profitable or not, but all are agreed on a high failure rate. Activist engagements have lower transaction costs than takeovers, often end with the target remaining listed on the stock market, and have a higher likelihood of success, at least in the US and Europe (Becht *et al*., 2017).

The internet and social media have allowed both shareholders and other stakeholders in the firm to coordinate and bring pressure to bear on boards. This stakeholder activism has been accompanied by pressures from public interest groups, demanding that companies become more responsible citizens and take account of what economists call externalities, for example environmental and social factors. For one major UK asset manager these issues constituted almost 20 per cent of its engagements with target companies in its portfolio (Becht *et al*., 2019). Larry Fink, CEO of BlackRock, in his annual letter to investors, said that within 5 years all investors will measure a company's impact on society

[4] An example is the hostile takeover by Melrose, a conglomerate, for GKN in 2018. Melrose specializes in buying poorly performing companies, improving them, and selling them on. GKN was larger than Melrose and had reported a profit warning to the market, largely due to its underperforming US aerospace business; this combined with a change in CEO made it vulnerable to a takeover.

and the environment to determine its worth.[5] Nor are the stock markets indifferent to this stakeholder activism.

In this paper we address the importance of various forms of ownership in the major stock markets and how ownership might influence governance and ultimately performance. We begin by describing the importance of institutional ownership in the governance of listed companies, and how those owners engage with the management of companies in their portfolio, and, in particular, the issues that motivate the engagements. The answers to these question depend upon the type of institutional owners, for example whether they are active or passive (index) funds, or hedge fund activists. We also discuss how successful these governance interventions by different institutional investors are, and finally, the regulatory response to some of the market failures arising from ownership in the public markets.[6]

II. Importance of institutional ownership in equity markets

In stock markets like the US and the UK, stocks in listed equities are largely held by financial institutions and intermediaries, including pension funds, insurance companies, and mutual funds. An important characteristic of these funds is that they only derive benefits from their ownership in the form of dividends and capital gains. As a result, they are often referred to as outside shareholdings.

Although these collective funds are large, for example BlackRock has assets under management of almost 7 trillion dollars and Vanguard more than 5 trillion dollars, the average size of their equity stakes is no more than around 4 per cent. This makes it difficult to exert ownership rights, unless they can coordinate with other shareholders. Coordination raises three issues: (i) institutions compete with one another and may obstruct coordination; (ii) coordination may make parties insiders, and therefore restrict the trading of their stakes, both buying and selling; and (iii) coordination can trigger 'concert party' rules in the UK, or a 'registered group' in the US—in that event, stakes will be amalgamated, potentially triggering regulatory thresholds.[7]

There has been some effort to limit the impact of these rules inhibiting coordination. In 2014 the Investor Forum was established in the UK to facilitate coordination between different shareholders so as to promote collective engagement with UK listed companies.[8] It was intended to circumvent some of the problems described above. In 4 years the Investor Forum has engaged with 23 UK companies. An example was the engagement with Unilever, where the company had proposed moving its head office from London to the Netherlands. This was vigorously opposed by UK shareholders who were concerned about the greater protection afforded by laws in the Netherlands

[5] Larry Fink: 'BlackRock's investment stewardship engagement priorities for 2019 are: governance, including your company's approach to board diversity; corporate strategy, and capital allocation; compensation that promotes long termism; environmental risks and opportunities; and human capital management.'
[6] See, for example, Azar *et al*. (2018).
[7] For example, in the European Union there is a mandatory bid rule at 30 per cent. If there are three shareholders with a 10 per cent shareholding, then if they were classified as a concert party, they would be compelled to launch a bid for the remaining shares at the highest price paid in the preceding 12 months. There are lower thresholds that are subject to different regulatory requirements.
[8] The investor forum was established in response to the 'Kay Review of UK Equity Markets and Long Term Decision Making', July 2012.

against hostile takeovers, as well as uncertainty as to the tax treatment of dividends. The Investor Forum successfully coordinated action by a group of shareholders to vote against the move, and have it rescinded.

In countries other than the UK, ownership of many listed companies is more concentrated, with a much reduced role for institutional shareholders. For example, in Germany about one-third of listed companies are controlled by a family, defining control as ownership of at least 25 per cent of the equity (Franks *et al*., 2015). In Italy the proportion is even higher.[9] These shareholders are not only larger and therefore less affected by problems of free riding, but even more important, they derive (private) benefits above and beyond the dividends and capital gains accruing from the shares; for example, management succession may be based upon kinship. As a consequence, they are often described as insiders, in contrast to institutional shareholders who are classified as outsiders.

Differences in the size of share stakes and in their ownership have important implications for how governance is exercised. I have already commented on the potential market failures of fragmented ownership in the US and the UK. In Germany, where family control is an important part of the landscape of ownership, governance will be very different since either members of the family will be directly managing the company, or they will be involved in selecting and even dismissing the management. The result is less free riding and smaller agency costs. However, the elimination of one market failure may give rise to another. The family may extract private benefits of control, such as appointing family members to the board and to other management jobs even when their skillset does not deserve it. The better family firms will be prepared to appoint professional managers. Families may also extract other benefits, for example, in related party transactions, where they move wealth from the public company to their private companies, often referred to as 'tunnelling'.

Depending upon the jurisdiction, the law may prevent the family from exploiting the company, by requiring the disclosure of related party transactions, giving extra rights to minority shareholders, and limiting other private benefits. But, they are unlikely to eliminate them entirely, and indeed it maybe undesirable to do so, since some private benefits may have a positive value for the company. Family succession may help to enhance the brand, while also promoting long-term investment. Restricting family control might encourage families to sell out.[10] In this event, we would revert to the fragmented ownership model of the UK with its associated agency problems.

Thus, in any comparison of stock markets involving fragmented ownership and family ownership, there will be a trade-off between one market failure and another, agency costs and free riding on the one hand and private benefits of control on the other. The size of private benefits has been measured in various studies and varies considerably across countries. Historically, they have been very high in countries such as Italy, South Korea, or Russia, where rights of non-controlling shareholders have either not been protected or been poorly enforced (Dyck and Zingales, 2004). In contrast, they have

[9] See Franks and Mayer (2017, Table 10).

[10] When Rupert Murdoch wanted to find a successor for his News Corporation Empire, listed on the London Stock Exchange, he had to set up a committee to vet all possible candidates. Fortunately for him, they chose his son James Murdoch, as best suited to the job. It is rumoured that the HBO series *Succession* is based upon the Murdoch family empire. See *Vanity Fair*, 'Succession: The real rich media family that inspired Logan Roy's new nemesis', 26 August 2019.

been low in countries with high levels of investor protection, such as the US and Germany, and in Scandinavia (see, for example, La Porta *et al*. (1998)).

So far we have focused on institutional shareholders, defined as outsiders, and family shareholders, defined as insiders. There is another class of owners that may have an effect on governance, and that is corporate owners, which were in the past significant in Germany and are still significant in Japan. Japan is particularly interesting because corporate ownership has taken the form of cross ownership, where two companies take an equity interest in each other, either to cement a strategic partnership (Franks *et al*., 2019), or to protect one another against a hostile takeover or an unwelcome approach by a shareholder activist.

In Germany, corporate holdings were often owned by banks, which performed a strong governance role. For example, in 1990 the large majority of German listed companies, 85 per cent, had an owner with at least 25 per cent of the equity. Banks owned a significant proportion of these stakes and other corporates held an even larger proportion (Franks and Mayer, 2001). One consequence was that from the Second World War to 1990 there were virtually no hostile takeovers in Germany, and in the case of the three that were launched, two failed.[11] By 2019 corporate stakes of this size had declined, including those held by banks.

It should be clear that ownership matters: who the owners are, the size of their stakes, and how they exercise governance. The persistence of particular forms of ownership will be influenced by how laws and institutions deal with any market failures. For example, in Germany there are laws limiting the private benefits that large shareholders may extract from their ownership.[12] In the UK, company law gives rights to shareholders to vote against certain classes of management decisions, for example mergers, mitigating agency problems.[13] In Italy, the law mandates that minority shareholders must be represented by a non-executive director, and related party transactions must be disclosed and approved by shareholders.

In Table 1 we provide a description of ownership in four major stock markets for the years 2000, 2006, 2010, and 2014. We have decomposed ownership into various categories. Domestic institutional owners include insurance companies, pension funds, mutual funds, and investment trusts. Foreign institutional investors are included in the category 'rest of the world', which includes foreign mutual funds, pension funds, insurance companies, and sovereign wealth funds. In one respect 'rest of the world' is overstated. Foreign mutual funds such as BlackRock, Fidelity, and Vanguard are classified as US funds, but have many UK and German investors that purchase US mutual funds and therefore would be included in 'rest of the world', when they should be classified under domestic

[11] For example, the bid by Pirelli for Continental tyre company failed. The only case where the hostile bid succeeded was the bid by Krupp for Hoesch. In this case, Krupp amassed a stake of 24.5 per cent prior to bidding, without declaring it, since German takeover rules at that time permitted a bidder to declare a stake only when it reached 25 per cent. See Franks and Mayer (2001) for a detailed description of these three takeovers.

[12] For example, in 1999 the CEO of Mannesmann faced criminal charges for accepting a bonus payment after the takeover by Vodafone. The prosecutor claimed Klaus Esser's conduct in the takeover had been influenced by the possibility of financial reward, resulting in a breach of trust. The prosecution was dropped only after Esser paying €1.5m.

[13] See, for the US and UK respectively, Li *et al*. (2018), and Becht *et al*. (2016).

mutual funds.[14] I have made some crude estimates, and the adjustments are not large: 4 per cent for the UK and 1 per cent for Germany; I have not made an adjustment for Japan.

The rest of the world category, or what might be termed foreign ownership, is usually the largest, and in 2014 was more than 50 per cent in the UK, 56 per cent in Germany, and almost 30 per cent in Japan. In the case of Japan, foreign ownership has risen to about 33 per cent by the end of 2018. The lowest is the US where foreign ownership is only 16 per cent.

Table 1: Ownership in UK, US, Germany, and Japan (%)

United Kingdom[a]	**2000**	**2006**	**2010**	**2014**[b]
Rest of world	36	40	43	51
Individuals	16	13	11	12
Non-financial investors	–	–	–	–
Insurance companies	21	15	9	6
Pension funds	18	13	6	3
Investment funds/mutual funds	1	2	9	11
Other financial institutions	3	10	12	7
United States	**2000**	**2006**	**2010**	**2014**
Rest of world	9	12	13	16
Individuals	43	30	37	39
Non-financial investors	1	0	1	5
Insurance companies	6	8	7	2
Pension funds	19	23	16	13
Investment funds/mutual funds	18	24	18	24
Other financial Institutions	1	4	4	6
Germany	**2000**	**2006**	**2010**	**2014**
Rest of world	–	54	55	56
Individuals	–	11	13	12
Non-financial investors	–	16	19	18
Insurance companies	–	3	2	1
Pension funds	–	8	6	6
Investment funds/mutual funds	–	6	3	5
Other financial Institutions	–	0	0	0
Japan	**2000**	**2006**	**2010**	**2014**
Rest of world	17.4	25.7	24,8	29.7

[14] Ideally, for each country we would deduct local ownership for every foreign fund and add them to the domestic category of mutual funds/investment trusts. Instead, we have only been able to collect UK, German, and Japanese ownership data for one year, 2014, in the three US funds listed above. We have taken local ownership reported by the mutual fund, converted the percentage ownership into a dollar value, then converted it into the local currency and divided it by the value of the equity of the local stock market. That percentage ownership has been deducted from the 'rest of the world' and added to the domestic mutual fund category. These adjustments must be regarded as approximate and almost certainly a lower bound.

Individuals	17.9	17.3	18.9	16.2
Non-financial investors	20.3	19.5	20.0	20.1
Insurance companies	10.1	6.9	5.9	4.7
Investment funds	7.7	7.5	7.1	6.2
Other financial institutions	26.7	23.1	23.3	23.1

Notes: [a] See for example, Azar *et al*. (2018). [b] 2014 data in the UK and Germany have been adjusted to account for local ownership of large institutional investors, namely Blackrock, Vanguard, and Fidelity. The three asset managers are categorized as foreign investors in the rest of the time series. In the UK and Germany this adjustment accounts for 2 per cent and 1 per cent, respectively. Thus, mutual fund ownership of local investors is increased by 2 per cent and 1 per cent, respectively, whereas foreign ownership is reduced.

Sources: UK ownership data were obtained from the Office for National Statistics. Ownership for the US was taken from the Federal Reserve Board. German ownership data were taken from the Bundesbank and include all listed companies. Data for Japan were taken from Tokyo Stock Exchange and include statistics for all listed companies. The numbers have been normalized to sum to 100 per cent; the unadjusted numbers sum to 108 per cent and reflect a degree of overlap in categories.

The pattern of ownership in the US has not changed nearly so much as the UK. In the US, what is striking is the share owned by individuals which is 39 per cent in 2014, largely unchanged from 2000. There has been a rise in foreign ownership from 9 to 16 per cent over the 14 years, with a decline in pension fund ownership from 19 to 13 per cent.

In Germany, foreign ownership and ownership by individuals is similar in trend and levels to the UK. However, there is one big difference and that is in the category of non-financial investors, which is largely made up of family ownership and is 18 per cent in 2014, compared with virtually zero in the UK, where family ownership has largely disappeared from the main listed markets. German non-financial ownership, or what we now refer to as family ownership, is largely concentrated in about one-third of listed companies, where families have ownership stakes of 25 per cent or more.

Japan shows considerable differences from the UK. Foreign share ownership in Japan is high, albeit lower than the UK. In contrast, ownership by individuals is much higher in Japan at 28 per cent, and non-financial, mainly corporate, ownership is also high in Japan at 17 per cent. Corporate ownership in Japan is particularly important, because it often takes the form of cross holdings where one company owns stakes in another company often used as a mechanism for protecting the companies against unwelcome takeovers or activist interventions. Even so, individual corporate stakes in Japan are not large, often only 2 or 3 per cent, rather than the family stakes of 25 per cent or more we see in Germany.

In summary, Germany is different from the Japan, the UK, and US, because it has a large proportion of listed companies with a controlling shareholder, frequently a family. Japanese and UK stock markets are highly fragmented, but corporate holdings are far more important in Japan than the UK or US, and are often used for mutual protection against unwanted advances. Some commentators refer to Japan as an insider system because corporate holdings are regarded as insiders, motivated as they are by much more than dividends and capital gains, often control considerations.

III. How do asset managers engage with portfolio firms?

In this section I compare and contrast how three types of institutional asset managers engage with target firms in their portfolios: the active asset manager, the passive or index fund manager, and the hedge fund activist. In Table 2 I examine the resources available for engagement for three types of asset managers.[15]

Table 2: Resources devoted to engaging with target management by various kinds of asset managers

	Passive manager	**Active manager**	**Activist hedge fund**
Stakes held	Hundreds to thousands	Hundreds	Typically <20 companies
Fund can vote/complain/ engage (‘Voice’)	Yes	Yes	Yes
Fund can SELL (‘Exit’)	No	Yes	Yes
Workload per governance team member	~200 companies per person, per year	~20 companies per person, per year	~1 company per person, per year

In the case of the passive or index funds manager and the active asset manager, I have included only the members of the governance and stewardship teams. There are several reasons why such comparisons are crude. There may be an engagement with target management by the fund manager, although this will likely be relevant for only the active fund manager, and not the index fund. Also, in both active and passive asset managers, the governance effort will be focused on engagements with a particular subset of companies where there are perceived problems of underperformance in some governance aspect. Thus, while the last row of the table provides an estimate of the number of target companies per member of the governance team, it is less the absolute numbers that are important, and more the relative numbers between each type of asset manager that should attract attention. For the shareholder activist it is roughly one company per team member. This low number should not be a surprise, since it has only about 10 to 12 companies at any one time in its portfolio, charging fees of

[15] We have taken the size of the governance teams and the number of companies invested in from public sources. We have not identified the particular asset managers the figures are based upon.

around 150 basis points on the capital invested. In contrast, the active asset manager has one member per 17 companies, while the manager of index funds has one member per 200 companies.[16]

The figures on resources should be considered in the light of the engagement objectives of the asset manager. The activist will be seeking strategic changes in the companies it has stakes in and, as a result, it will invest considerable resources in researching the company and the industry and speaking to the management, other shareholders, and even ex-employees. They will also have purchased their stakes largely if not exclusively for the purpose of achieving these strategic changes. Once they are achieved they are likely to exit the position.[17] The average holding period for their stakes is about 2 years, although there are some activists, particularly those who take board positions, like Cevian Capital, who hold for longer periods, up to 5 years.

In contrast both the active and the passive asset manager will be long-term holders in many of the stocks they invest in. They do not usually engage in anything like the intensive way that hedge fund activists engage, and equally important they do not engage often on the kind of strategic issues that interest the activist. The governance team at the active and passive asset managers will engage mainly on three issues: compensation, board governance, and social issues including diversity and environment—largely, but not always, missing from the agenda of the activist.

(i) Active asset manager

There is relatively little direct evidence on how asset managers engage with portfolio companies; an exception is the paper by McCahery *et al*. (2016). Another is a working paper by Becht *et al.* (2019) that lays out the interactions between a large UK asset manager, Standard Life Investments (SLI), and the target firms in its funds. It is worth noting that Standard Life Aberdeen (SLA) has more than 100 different funds, although this paper focuses on about 50 purely UK equity funds. SLI also has a centralized governance and stewardship team (G&S) that engages with the target firms about the three issues listed above: board composition, compensation, and environmental and social issues. Importantly, the voting manager who votes all the shares held by every fund sits within the G&S team. The shares of all funds will be voted as a block, and individual funds have no discretion on voting the shares of their particular fund.[18]

SLA does not invest to engage, but once it has invested monitors the portfolio company and engages when necessary. As Becht *et al*. (2019) point out, there are two important issues that arise from these engagements. First, to what extent do these engagements result in changes to the target company, and conditional on these changes do they enhance the value of the company? Second, are the engagements about collecting information so as to improve the stock picking of the fund managers, and thereby encouraging adding to or selling the stake? In other words, do these engagements add value to other

[16] I have estimated these numbers from three particular asset managers. Because they are for illustrative purposes only I have not named the asset managers.
[17] Sometimes there will be multiple activists with stakes in the same target. They will be careful not to cooperate too closely for fear of becoming insiders.
[18] The internal organization differs between asset managers. For example, Becht *et al*. (2019) study SLI before its merger with Aberdeen Asset Management to form SLA. In the case of Aberdeen there was no centralized G&S team; the fund manager monitored and engaged.

shareholders of the target company or do they simply facilitate trading by the fund managers? Becht *et al*. (2019) provide evidence that SLI does collect information from their engagement and they trade profitably on it. They also provide some case studies where engagement does affect outcomes. One case they cite is that of Vodafone, where SLI was opposed to the strategy of Vodafone and voted against the reappointment of the CEO leading to his replacement.

(ii) Index funds

The principal difference between the active asset manager and the index fund manager from a corporate governance point of view is that the former can use voice and exit, whereas the latter can use voice only. By voice we mean engaging with target management through meetings, emails, and calls. By exit, we mean selling the shares in the target company because of what has been learnt about the target company or because the engagement has failed. One theory suggests that if the management of the target knows that the asset manager can exit because of liquidity, they will be concerned at the signalling effects of the sale and be prepared to engage more constructively. If this is true there is an advantage held by active asset managers not available to index fund managers who cannot take advantage of liquidity and exit because of perceived poor engagement. [19]

Another theory has a very different outcome, that is, the ability to exit might lead to an under-investment in governance because it is cheaper for the asset manager to 'cut and run' rather than to try and engage with a firm that is resistant to change. This may be particularly important if the liquidity of the stock is high, thereby providing low transaction costs to exiting. If this theory is correct, then exit may be profitable as an alternative to voice, and lead to an under-investment in monitoring and engagement. However, Table 2 suggests that the resources devoted to G&S look considerably higher for the active asset manager compared with the index fund manager.

An important question is whether engagement by index funds has any effect on the target company. In research published by Appel *et al*. (2016), they find that passive investors influence governance by (i) increasing the number of independent directors and therefore the independence of the board, (ii) removing takeover defences such as poison pills, (iii) reducing the restriction on shareholders to call special meetings, and (iv) reducing unequal voting rights. They improve the long-term performance of the shares of target companies through their engagements, measured by Tobin's Q and return on assets. Their interventions, they claim, also have a spillover benefit by reducing the need for engagement by hedge fund activists. Thus, their evidence suggests that voice without exit can still produce outcomes for the target firm and lead to increases in their valuation. In another paper, Li *et al*. (2019) find that mutual funds reduce their holdings when the outcome of votes at shareholder meetings are opposed to their own voting decisions.

[19] See Edmans *et al*. (2013). They found that liquidity increased the likelihood of block formation. Conditional on the acquisition of a stake, liquidity results in more exit and less voice. However, the threat of exit has a positive effect on governance.

(iii) Hedge fund activism

Table 2 shows how much greater resources are spent by the activist compared with other asset managers. Moreover, the issues engaged on are very different. The activist concentrates on strategic issues, which often involve restructuring the company through spin-offs of subsidiaries, sale of assets, and putting the company 'into play', i.e. through being acquired. Other objectives include increases in payout and changes to the board. Often changes to the board are necessary to implement the strategic demands of the activist. However, recently there have been calls for the activist to engage in wider issues that involve environmental and social issues. Christopher Hohn's activist fund, TCI, has outlined plans to punish directors of companies that fail to disclose their carbon dioxide emissions, in response to concerns over climate change.[20] This is one of the most aggressive stances taken by any asset manager to climate change.

The demands of the activist often meet resistance. In a clinical study of private engagements by an activist, the Hermes Focus Fund, Becht *et al*. (2008) find that Hermes often achieved their strategic objectives by confronting management and forcing the resignation of the CEO or chairman. For the 30 engagements examined, the stakes averaged around 2.5 per cent, but where the engagements were confrontational the size of stakes was much greater, at 7.5 per cent. Very often the activist could only achieve its objective by attracting the support of other shareholders. This meant buying into companies, with concentrated institutional ownership. In Hermes' targets, the top three shareholders, other than Hermes, held stakes totalling almost 20 per cent, thereby providing it with the potential for support.

In the majority of cases, Hermes faced resistance and as a result demanded the resignation of the CEO or chairman. Those announcements were accompanied by an increase in the stock price of about 3.5 per cent for the 11-day window around the announcement date. More generally, there were about two outcomes for each firm targeted during the period of the engagement, and those outcomes were accompanied by further increases in the stock prices of 3–4 per cent. The result was that the fund earned significant excess returns during that period, which the authors attributed to active engagements.

In a larger study Becht *et al*. (2017) examined 1,740 engagements by activists across 23 countries in Asia, Europe, and North America. Many of those engagements were concentrated in only a few countries, particularly Germany, Italy, Japan, UK, and the US. For all these countries the level of activism was far greater than the incidence of hostile takeovers. It seems likely that activism was in some cases a substitute for hostile takeovers and the market for corporate control.

In their sample, the stake held by the activist averaged about 11 per cent of the target company. However, in more than 20 per cent of cases more than one activist was involved with the same target, and the combined stake was about 13 per cent. The authors estimated that the excess share price returns on announcement of the share stake held by the activist, was about 7 per cent in North America, 4.8 per cent in Europe, and 6.4 per cent in Japan. Although these abnormal returns are similar, the outcomes were very different. In Europe and North America there was a very high rate of success: in the US there were outcomes in 61 per cent of engagements and in Europe 50 per cent; in sharp contrast, in Japan the success rate was as low as 18 per cent. The important conclusion of the

[20] See *Financial Times*, 'TCI boss calls for fund managers to be fired over emission failures', 2 December 2019.

study was that there were only excess returns to the engagements when there were outcomes; where there were no outcomes the excess returns over the engagement period were zero or even negative.[21]

It is interesting to examine the reason for the disappointing results for Japan. One is that the culture of Japan rejects the confrontational approach favoured by many activists. Also, Japanese institutional investors have historically not intervened in the management of the companies they have held stakes in. That culture may be changing in response to the recent actions of the Japanese government which is encouraging more active engagements by investors through changes in the governance of listed companies. Another reason to expect changes in attitude towards activism is the increasing proportion of foreign shareholders in Japanese equities. Foreign investors will be less influenced by culture and domestic considerations, and more interested in improving their returns.

IV. Public policy

Is the decline in the number of UK (domestic) and US listed companies a cause for concern? If the cause is the thriving nature of the private capital markets, then the answer is a qualified no! We should not complain if the costs of the private capital markets have declined so much relative to the public markets, so that it is no longer cost efficient for firms to 'go public'. Indeed, to talk of the private and public capital markets as though they are entirely separate may not be accurate, since many institutions that are active in the public markets have also become active in the private markets. There is therefore a blurring of the differences between the private and public markets. For example, Heathrow Airport is a private company, and it has seven institutional shareholders, including a UK pension fund (Universities Superannuation Scheme or USS), two sovereign wealth funds (Quatar Holding and the Government of Singapore Investment Fund), and a Spanish Construction company (Ferrovial, who operates the airport). However, there is a cost to these private markets, in so far as individuals can no longer directly invest in these companies, and such companies are no longer included in the market index. Only if individuals are shareholders in the institutions that are the direct investors can they participate at all.

A second objection to these private capital markets is that private equity, which has been responsible for a significant part of the decline in public markets, has achieved its returns in part at the expense of other stakeholders. Morris and Phalippou (2020, this issue) write that 'private equity can be thought of as an extreme form of the shareholder-value model of capitalism . . . Some of these sources [of returns] are socially useful, others neutral, while others yet may have negative social impact'. There is also the issue of disclosure and regulation. Private capital markets are subject to much less disclosure and regulation. Given that the large majority of even large companies are private, the lack of disclosure and regulation may not always improve welfare.

There is, however, a less benign explanation for the decline of the listed markets, and that is their increasing cost. An important cost, referred to earlier, is the agency costs arising from the separation of ownership and control combined with the fragmented nature of ownership, typified by UK listed

[21] There are also spillover effects of activism. See Gantchev *et al.* (2018). They find that the positive effects of activism spill over to non-targeted peers. The peers facing the greatest threat of activism, increase their leverage and pay-out, decrease capital expenditures and cash, and improve return on assets and asset turnover.

companies, but very much present in other stock markets like the US and Japan. In these stock markets the governance of the companies is largely in the hands of institutional investors. However, these institutional investors hold small stakes, and their business model is based upon low fees, with the result that the resources devoted to monitoring the target company and intervening are inadequate. In this respect the growth of index funds may have brought with it a decline in the monitoring of companies and a weakening of external governance. In addition, with the exception of activist hedge funds, asset managers of all classes do not involve themselves in the strategy of the company and correcting under performance. This is the price that is paid for the absence of controlling shareholders.

Other stock markets, like those in Germany, have an advantage in so far as they include both a significant proportion of family-controlled companies as well as companies with widely dispersed ownership. As a result, there is a choice of what form a company's ownership can take in their listed markets. In contrast, in the UK market there is virtually no choice in the primary market; virtually all companies have fragmented ownership structures and remarkably few are family controlled, particularly among the larger companies. Even if it is not obvious which form of ownership is superior, it may be unwise for a capital market to rely on only one form. It is unlikely that one form of ownership suits all companies. Ownership may be endogenous to particular products and industries.

One solution for capital markets like the UK, is for the regulatory authorities to encourage family companies to list and to encourage large blocks to form; or rather reduce the impediments to controlling shareholders. These regulatory changes might take a number of forms, as follows.

(i) Abolish the EU mandatory bid rule which requires a shareholder with a 30 per cent stake to bid for all remaining shares.[22],[23] An alternative is to raise the threshold to, say, 50 per cent.

(ii) Permit dual class shares at the IPO stage so as to permit families to retain control even when their share of cash-flow rights falls below a controlling stake. In order to prevent exploitation of other shareholders, sunset clauses might be included, which allow all shareholders a vote to renew the dual-class structure, after a fixed number of years.[24]

(iii) Relax the rules on insider trading and concert parties so as to increase coordination among shareholders.

(iv) Allow for more shareholder votes, including on social issues such as a company's contribution to carbon footprint, and make it easier for shareholders of listed companies to pre-commit the company to a broader corporate purpose.[25]

For other capital markets where there are controlling shareholders, the critical objective is to ensure that there are laws in place that prevent exploitation of outside shareholders. While this will reduce private benefits of control it will not, and should not, eliminate them entirely. Some private benefits may have a positive value to outside shareholders and other stakeholders. For example, family succession is an important reason for family ownership and, without that, it is likely that many family

[22] This does not include large block holders who were pre-IPO shareholders.
[23] Some countries like France permit loyalty shares where shareholders have more votes the longer the holding period. See Becht *et al.* (2018).
[24] For a very negative view of dual class shares, see Bebchuk and Kastiel (2017).
[25] See, for example, Hart and Zingales (2017) and Mayer (2018).

companies would relinquish their ownership, particularly since they are undiversified (see Villalonga and Amit (2020, this issue)).

V. Conclusion

Ownership clearly matters. However, it is unclear which model of ownership is best, or even whether there is a 'best model'. It is likely that owners choose a particular form of ownership that maximizes their value. Moreover, when circumstances change, the ownership might also change. Dell Computers moved to the public capital markets, went private, and then returned to the public capital markets.

However, different forms of ownership are subject to different costs and benefits. Companies with fragmented ownership are likely to suffer from agency costs and a lack of monitoring by shareholders. These agency costs appear to be high, witness the large premiums paid by private equity firms for listed companies. Shareholder activism is likely to have reduced these agency costs, however activism remains a very small segment of the stock market, around 1 per cent. These agency costs are much smaller when there is a controlling shareholder, but there may be private benefits accruing to those shareholders, and those private benefits may come at the expense of outside shareholders. Regulation and culture can significantly reduce those private benefits, in particular where they lead to expropriation.

Laws, regulation, and custom have altered the relative costs of different forms of ownership. An example is the UK which has banned dual-class shares from the main listed London stock market. In addition, it has placed barriers to accumulating large share stakes through disclosure, mandatory bid rules, and equal price rules. As a result, the number of companies with controlling shareholders are far fewer in the main London market than virtually anywhere else in the world. There is also a virtual absence of family ownership in the listed markets.

The relative costs of the private and public markets have also changed in recent years. There is an increased willingness by financial institutions to finance private companies, while the growth of non-bank intermediaries has increased the access of private companies to external finance. Indeed, the differences between private and public markets in terms of access to finance have been reduced, if not blurred. One very important difference is in disclosure and regulation, with private companies favoured over public ones.

What should government and regulators do? I think it would be wise for regulators to encourage different forms of ownership, or rather recue the bias in favour of one form of ownership over another. For example, the UK should reduce the bias against controlling shareholders. The concept of a level playing field between different shareholders has become the hallmark of UK regulation. This has imposed high costs on controlling shareholders. The policy advocated here is for regulation to encourage different forms of ownership that compete with one another within the same market. In particular, stock markets like the UK should give up their prejudice against controlling shareholders. Level playing fields are more relevant for cricket than they are for financial markets. In addition, stock markets with controlling shareholders should avoid copying UK rules. Rather they should enhance different forms of ownership and welcome the competition between them.

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