

# Substance or symbolism?

## *Corporate governance practices of institutional investors*

REPORT TO EUMEDION |

NEDERLANDSE CORPORATE GOVERNANCE STICHTING

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With cooperation of:

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**April 2007**



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## | SUMMARY

This study focuses on the shareholder activities of institutional investors. It covers three main areas: (1) a concise review of relevant theory and existing empirical research, (2) a discussion of legal issues that arise when investors intend to become active on their shareholdings in the Netherlands, and (3) an empirical analysis based on both interviews with key representatives of Dutch institutional investors and a survey sent to institutional investors in 8 different countries.

Shareholder activism is best understood as a means of corporate governance in the pursuit of shareholder wealth maximization. This perspective leads us to define shareholder activism as all actions, other than seizing control or selling shares, that shareholders undertake within a *given* shareholder relationship with a portfolio company in order to influence either the governance, management or performance of that company. This definition has a relatively broad extension and includes both private and public actions, as well as both passive and more active shareholder activities. We also use this relatively broad definition in the measures of shareholder activity that we employ in our empirical research.

From the literature survey, we find that the utility of shareholder activism as an instrument of corporate governance is largely conditioned by the factors that burden shareholder activities. These factors affect the transaction costs and collective action problems that burden shareholder activities, and generally include: (1) the degree to which shareholdings are dispersed, (2) informational and legal barriers that stand in the way of exercising shareholder voice, (3) and the level of inside ownership in the target firm. Inversely, factors that facilitate shareholder activism include: (1) ownership concentration and (2) the degree of institutional ownership on the one hand, and (3) the absolute size of the equity holding in the target firm, on the other. Because the factors that burden shareholder activities are abundantly present, some authors have claimed that shareholder activism makes little sense, except under very specific conditions. And because these conditions are found to be relatively rare, shareholder activism, in this view, is seen as an *ultimum remedium* that should be put to use only after making a thorough cost-benefit analysis. Ultimately, however, it is the availability of the option of shareholder voice, rather than its actual exercise, that matters most.

The bulk of empirical research on shareholder activism has focused on the relation between activism and performance and is mostly about shareholder activism in the United States. The results are mixed: some studies find positive effects of shareholder activism on targeted firms, while others conclude that shareholder activism has a negligible impact on target firm performance.

We argue, however, that research and theory building that is not directly related to shareholder activism may also shed interesting light on the factors that drive institutional investor activism. More specifically, research on economic organization in general indicates that organizational forms and policies are often not rationally adopted on account of their functionality, but are rather symbolically adopted in order to secure legitimacy from the organizational environment. These so-called ‘institutional’ explanations of organizational structures and policies have already been found to be empirically very powerful in corporate governance research in general. This has drawn our attention to the ceremonial dimension of shareholder activism. It should be clear, however, that a symbolic interpretation of shareholder activism defies the instrumentally rational understanding that currently dominates the field.

Concerning legal issues regarding shareholder activities in the Netherlands, shareholders who wish to vote at a general meeting of shareholders have to meet certain legal requirements. Dutch law was recently changed, and these changes affected shareholders rights. We identify a number of impediments for shareholder activism, of which three are particularly relevant: stock lending, corporate governance issues/shareholder rights, and ‘acting in concert’. Regarding lending, this is an increasingly important practice that should improve market liquidity. The

word lending, however, has misled many since from a legal point of view the transaction is an absolute transfer of title against an undertaking to return equivalent securities (consistent with Dutch law). Misconceptions could lead to loss of shareholders votes in important situations as well as to cases of shares being voted by parties who have no equity capital at risk in the issuing company, and thus, no long-term interest in the company's welfare. Corporate governance policies might be at risk, because of a lack of coordination with lending activity. With respect to shareholder rights, the European Union agreed to a directive to ensure that shareholders have timely access to the complete information relevant to general meetings and that facilitates exercising voting right by correspondence and by proxy. Furthermore, it should abolish the main obstacles that exist in cross-border voting, i.e. share blocking, insufficient or late access to information, and overly burdensome requirements on distance voting, whereas the right to ask questions should be accessible to non-residents and voting results should be available to all shareholders and posted on the website. A third impediment constitutes the view that current regulations are not clear enough specified to answer the key questions when shareholders abuse market rules and 'act in concert'. This situation might prevent certain shareholders from voting or engage in other shareholder activities. Finally, we address the issue of electronic voting. New legislation, effective January 1, 2007, regarding the use of electronic means to facilitate the participation of shareholders at shareholder meetings entail, among other things, the use of electronic means to enable shareholders to take note from a distance of the discussion transacted at shareholders meetings, and to vote from a distance during the shareholders meeting, without having to appoint a proxy.

We conduct an empirical study consisting of expert interviews and a international survey. The relative dominance of pension funds in our sample sets constraints on the conclusions that can be drawn from our empirical research. More specifically, our findings may not be representative for non-pension fund investors, particularly not for international non-pension fund investors. Within the group of pensions funds, however, a meaningful distinction between Dutch and international pensions funds can be made.

A first set of findings indicates that there may be an important ceremonial dimension to shareholder activism. This is manifest, first, the responses to questions in our survey that we asked only Dutch investors. These questions pertain to the practice of lending shares to other investors. Apparently, this is a wide spread phenomenon in the Netherlands. A large majority of Dutch investors report that they lend shares to other investors (pension funds:62%, other investors:71%), and when they do, it involves a significant part of the portfolio (pension funds:10%, other institutions15%). Yet at the same time, voting rights on shares lent are never retained by the lender, while shares are seldom recalled to vote and borrowers are hardly ever given instructions or required to provide assurance on instructions given. Moreover, we found from the interviews that lending desks often operate separately from the officers involved in voting. Thus although share lending is widely practiced, it seems hardly developed in regard to shareholder activities. Perhaps this is an indication for the real importance that investors attach to voting. It also raises the question whether current practices regarding share lending are adequately institutionalised.

A second finding similarly questions the real importance to investors of shareholder activities. It involves the amount of resources dedicated to these activities. Consistent with other research, these are found to be small – around €100.000 – and spent predominantly on domestic investments. While the latter can be seen to be rational on account of the costs of shareholder activities increasing with distance (see below), the rather trivial amount of resources investors report to spend on shareholder activities indicates that there may be a significant ceremonial dimension to shareholder activities.

The risk of engaging in largely ceremonial shareholder activities, third, appears particularly high for international equity investments. For these shareholdings, proxy voting is the most important, and often the only activity institutional shareholders engage in. We have indicated, however, that the dominant role of ISS in the market for international shareholder services that our interviewees report may constitute a mechanism through which highly isomorphic shareholder policies and activities result from very uniform company reports and voting recommendations. This can be seen to increase the risk of developing largely ceremonial shareholder policies and activities that have hardly any functional relation to the instrumental purpose that shareholder activism presumably has.

A fourth indication that there may be a ceremonial dimension to the shareholder activities of institutional investors involves the motives that investors report for targeting firms for shareholder activities. For both international and Dutch pension funds (albeit the latter to a lesser degree), corporate governance issues are reported to be the most important trigger for shareholder activities. This is a remarkable finding given that empirical research reviewed in this report has not been able to document any positive effects of shareholder induced corporate governance reforms on firm value. That investors focus on corporate governance issues nevertheless, is easily explained. Corporate governance issues are relatively easy to observe – e.g. they are reported on by shareholder services providers as ISS – and are also easier to remedy than underperformance of listed companies, for example. Yet in spite of it being understandable, the focus on corporate governance issues challenges the rationality of much institutional investor activism.

Another set of interesting findings pertains to the questions that aim to measure the frequency and perceived importance of different kinds of shareholder activities that institutional investors engage in. We find that investors are generally more active on domestic investments than they are on international investments. This finding corroborated the picture that emerged from the interviews. Domestic activism is not only more convenient, but it is also cheaper, particularly for activities for which the cost increases with distance, such as attending shareholder meetings or engaging in private engagements with portfolio companies. This general home bias in shareholder activism therefore need not signal irrational behaviour (see below). Moreover, international pension funds reported to be generally more active than Dutch pension funds, while they also reported higher frequencies on distinctively public shareholder activities. The Dutch pension funds, in contrast, reveal a distinct preference for private activities.

We find, second, that pension funds generally find shareholder activities more important than can be inferred from the frequencies with which they undertake these activities. Although this finding should be interpreted with caution, it demonstrates the insight that the availability of options for shareholder activities are typically found to be more important than engaging in these activities. This is particularly true for activities that seem to be low base-rate phenomena to begin with, such as calling an extra ordinary shareholder meeting. Hence one should be careful to infer from a low degree of shareholder activities that these activities therefore do not matter much, as they matter most under relatively rare conditions.

A number of interesting insights result from asking investors directly for the motives that drive them to engage in shareholder activities. What is remarkable is that the motives that intended to capture rational decision-making on engaging in shareholder activities scored low across the board. More specifically, this means that investors believe that measuring the costs and benefits of their shareholder activities is relatively unimportant in deciding whether or not to become active on their shareholdings. This finding is consistent with what we learn from the interviews and speaks against a rational assessment of shareholder activities by investors, even if we discount for the methodological difficulties that frustrate measuring the benefits from shareholder activism. What is noteworthy, furthermore, is that Dutch pension funds reported to be driven mostly by considerations that intended to capture the symbolic and ceremonial dimension of shareholder activities, while the international pension funds reported to be motivated predominantly by the considerations that underlie a rational cost-benefit analysis.

In the final part of our empirical research we attempt to assess the relative effect of different factors on the degree of investor activism through a so-called regression analysis. A number of robust conclusions are drawn from this analysis:

1. Investors are generally more active in their home countries than in the foreign countries in which they invest. Although this is a remarkable finding, it can be seen as rational to the degree that shareholder activities become more expensive with distance. After testing whether this home bias applied to different kinds of shareholder activities, we found that it applies only for the kind of activities for which the costs increase with distance, such as attending shareholder meetings, or privately engaging with portfolio companies. The home bias can therefore largely be accounted for from a rational cost-benefit perspective.

2. Investors from the UK and Canada tend to be more active than investors from other countries. Although we provided no explanation for this finding, this may very well be because shareholder interests were voiced and organized much earlier in Anglo-Saxon jurisdictions than in the rest of the world.
3. The type of investor does not have a significant impact on the degree of shareholder activity. On account of the low number of observations in the non-pension fund investor category, however, this finding should be interpreted with caution.
4. Inversely to the theoretical expectations we summarized in chapter 2, we find that funds with obligations that derive from defined benefit pension plans are less active than funds with defined contribution pension plans. Apparently, the quality of monitoring on fund performance increases, rather than decreases, with the degree to which these funds have open ended obligations towards their beneficiaries.
5. Larger investors are more active. This pretty much confirmed the conventional wisdom according to which economies of scale and learning increase with size.
6. The three types of motives we have tried to operationalize – i.e. rational, cognitive institutional and normative institutional – are strongly interrelated, and always positively related to the degree of shareholder activity. Where these motives were made to compete, however, only the rational motives turned out to be a significant determinant of shareholder activism. This by no means concludes the issue whether shareholder activities are rational or whether they should be seen as largely ceremonial, even if only because of statistical and methodological limitations to our research. If anything, the results of the research reported here calls attention to this issue, which is relevant both for academics and practitioners.

# 1 | INTRODUCTION

It is something of an article of faith that institutional shareholders are critical to a well established system of corporate governance. Essential to this belief is that institutional investors should play an active, constructive and responsible role in the corporate governance of publicly listed companies. Most corporate governance codes around the world therefore call upon institutional shareholders to actively exercise their rights as shareholders of listed companies. At the same time, however, institutional investor activism is the subject of intensive debate. Academically, the corporate governance role of shareholders is highly contested, because both theory and the available empirical evidence seriously challenge the presumed beneficial effects of shareholder activities. In practice, the role of institutional shareholders is highly debated on account of the conspicuous role that some institutional investors – mostly hedge funds and private equity parties – currently play in the governance and reform of publicly listed companies. Compared to other corporate governance issues, however, the governance role of institutional shareholders has been relatively little researched. Theory building has resulted in partially contradictory predictions, while empirical research seems to be inconclusive on the issues that define the field. The main purpose of this research is to contribute to our understanding of the corporate governance role of institutional shareholders, with the ultimate aim to facilitate both the academic and practitioner debates on the rationality and desirability of institutional shareholders having a more active role in the corporate governance of publicly listed companies.

To achieve this objective, this report consists of three distinctive parts. The next chapter, first, provides a concise review of relevant theory and the empirical research on shareholder activism available to date. This chapter also defines the object of this study conceptually. It is argued here that *shareholder activism* – which is the term most commonly used in the literature – is to be understood as an instrument of corporate governance that presumably serves the ultimate goal of shareholder wealth maximization. As such, shareholder activism is defined as all actions, other than seizing control or selling shares, that shareholders undertake within a *given* shareholder relationship with a portfolio company, in order to influence either the governance, management or performance of that company. The subsequent chapter is written mostly for institutions that invest in the Netherlands, and involves the legal requirements and impediments that shareholders face when they become active in the Netherlands.. This part of the report can safely be ignored by readers who have no interest in Dutch legal issues in regard to shareholder activities in general, and voting in particular. Chapter four of this study consists an empirical study of shareholder activities conducted among institutional investors in eight different countries. The research design for this study included both semi-structured interviews with representatives of a variety of prominent Dutch institutional investors, and a questionnaire that was sent to institutional investors in eight different countries. This questionnaire contained: (1) general questions (characteristics of the institutions, asset management practices, and general policy regarding shareholders activities), (2) questions about actual shareholder activities and motivations for being active in their *home country*, as well as for (3) the country in which the responding institution holds the largest *foreign* equity investments. The results of this questionnaire are first described in some detail, after we further analyse the data by performing a regression analysis to uncover the main antecedents of institutional shareholder activism. We wrap up in chapter five by presenting and interpreting our main findings. We refrain from making any concrete policy recommendations, however, as there is currently no consensus on what objectives a policy on the corporate governance role of institutional investors ought to have, nor on whether such a policy is needed to begin with. As said before, our aim is first and foremost to contribute to the debates on institutional shareholder activism. In our view, such debates logically precede any attempt to formulate policy on the governance practices of institutional shareholders.

Finally, we express our sincere gratitude to all who have in any way or form contributed to the making of this report.



## 2 | THEORY AND RESEARCH ON SHAREHOLDER ACTIVITIES

In this chapter we provide a concise review of theory and research on governance activities of institutional shareholders. The purpose of this review is both to explain the basic concepts we use in this report and to provide some general background on what is known about shareholder activities, particularly those of institutional investors.

We first address the questions what shareholder activities involve and what purpose they serve, after which we take a closer look at the factors that condition the functioning of shareholder activism as an instrument of corporate governance. We then briefly review the most important empirical research on shareholder activities. We first address the shareholder activism-performance relationship that has been the main focus of most empirical research on shareholder activities. We also discuss some more fine grained issues that are easily lost in the instrumentalist focus that empirical research on shareholder activism typically has. We successively discuss: the question why shareholder induced corporate governance reforms do not seem to matter for financial performance; the differential performance consequences of different kinds of shareholder activities, target company selection motives and the factors that may explain shareholder activities of institutional investors more in particular. We conclude with speculating on why investors continue to engage in the kind of shareholder activities that have been found not to have any effect on firm value. We also provide a bibliography of relevant literature at the end of this report.

### The meaning and purpose of shareholder activism

Definitions of 'shareholder activism' – which is the term commonly used in the literature to denote the kind of activities this report is about – are either quite broad or more specific. Black (1998) provides an example of the former, defining shareholder activism as “proactive efforts to change firm behavior or governance rules”. Gillan and Starks (1998) exemplify the latter when they define a shareholder activist as “an investor who tries to change the status quo through ‘voice’, without a change in control of the firm.” These two definitions demonstrate that to define shareholder activism is already to say something about the presumed ends towards which shareholder activism is to be understood as a means (cf. Bainbridge, 2002).

Generally, this end is to change the governance, management or performance of a portfolio firm, with the ultimate purpose of maximizing shareholder wealth through alleviating the agency problems (Fama, 1980) that arise on account of the separation of ownership and control in public firms (Berle & Means, 1932; Jensen & Meckling, 1976). Furthermore, the means that shareholder activism provides towards that end must be understood in contradistinction to other possible means, mechanisms (Walsh & Seward, 1990) or constraints (Zingales, 1998), that presumably serve the same purpose. The most important corporate governance mechanisms are commonly held to include: incentives plans for managers, legal protection, board monitoring and the market for corporate control (Schleifer & Vishny, 1998).

Shareholder activism is to be conceptually distinguished from the latter precisely because it purportedly becomes a relatively more valuable instrument the less effective the market for corporate control becomes (Black, 1992; Pound, 1988, 1992; Wahal, 1996). For similar reasons it makes good sense to conceptually distinguish shareholder activism from ordinary portfolio management, because the more costly the “exit” option of selling the shares of a target company in secondary markets will be (Minow & Monks, 1991; Pozen, 1994), the relatively more valuable shareholder “voice” presumably becomes (Hirschman, 1970). In this report we will therefore understand shareholder activism – or interchangeably: ‘shareholder activities’ or ‘governance activities of shareholders’ – as all actions, other than seizing control or selling shares, that shareholders undertake within a *given* shareholder relationship with a portfolio company, with the purpose of influencing either the governance, management or

performance of that company.<sup>1</sup> Although this understanding of shareholder activism is conceptually clearly delineated from the other corporate governance mechanisms and instruments mentioned above, it has a relatively broad extension that includes both private and public communications and actions between shareholders and their target companies, as well as passive (e.g. information gathering) and more active (e.g. voting and submitting resolutions at general meetings) shareholder activities. This variety of activities is also operationalized in the measures of shareholder activity we use in our empirical research.

### **The functioning of shareholder activism as a corporate governance instrument**

Given that shareholder activism is to be understood as a means in the pursuit of the end of shareholder wealth maximization, it makes sense to take a closer look at the factors that presumably condition the functioning of this means of corporate governance. In general, shareholders in publicly listed companies retain control rights because not all that is relevant to shareholder wealth can exhaustively be provided for by substantive terms of the nexus of contracts that constitutes the public firm (Easterbrook & Fischel, 1991). Moreover, as a group, shareholders, who are residual claimants, constitute the only corporate constituency that has the proper incentives to maximize the long run value of the firm as a whole (Jensen, 2002).

At the same time, however, the bulk of everyday decision making in public firms must be delegated to managers on account of efficiency considerations, as shareholders of public firms typically have neither the means nor the incentives to make informed decisions on everyday corporate issues (Lipton & Rosenblum, 1991). But even if they could, it would still be inefficient for shareholders to be actively involved in running the company on account of both transaction costs and collective action problems that prevent shareholders from having an active role in the day to day operations of the firm. Normally, therefore, the control rights of shareholders in public firms consist only of the right to vote in general meetings, and even then only on a rather limited set of issues (Easterbrook & Fischel, 1991: 63-72). These issues by and large include board appointments and decisions on significant corporate actions, such as mergers and charter amendments (Kraakman, 2004). That the formal corporate governance role of shareholders is typically limited to voting on a limited set of issues does not mean, however, that shareholder activism is limited to voting at general meetings. Voting is best seen as the ultimate step in what very much resembles a “political” process” of *ex ante* engagement that includes the variety of activities we denote with the term shareholder activism (Pound, 1992, 1993).

Yet even the exercise of the limited control rights that shareholders have is problematic for shareholders. The reasons for this primarily involve the high transaction costs that burden collective decision making between dispersed shareholders, and collective action problems (Olson, 1965) that stifle incentives for individual shareholders to engage in shareholder activities (Downs, 1957). Because the presumed benefits of shareholder activism constitute a public good, individual shareholders are rational to remain inactive and free ride on the shareholder activities of others. This ultimately results in an undersupply of shareholder activity. The factors that condition the functioning of shareholder activism as a means in corporate governance are therefore for the most part the factors that burden or alleviate transaction costs and collective action problems in this context.

Conventional wisdom has it that the factors that burden shareholder activism include: the degree to which shareholdings in the target company are dispersed over different owners, the informational and legal barriers that stand in the way of exercising shareholder voice (see generally: Bebchuk, 2005), and the level of inside ownership in the target firm, which presumably is an indicator of the expected resistance against external shareholders seeking to influence either the management, governance or performance of the firm (Carleton, Nelson & Weisbach,

<sup>1</sup> Although we conceptually distinguish shareholder activism from ordinary portfolio management, we acknowledge that activism may very well include buying shares in a focal firm. Hedge funds often intentionally acquire (minority) positions in underperforming firms in order to move their managers to restructure and deliver shareholder value (e.g. Becht et al, 2006). Because both hedge funds and private equity funds typically do not provide public information, we have not included them in this study. We thank mister Peters for calling our attention to this issue.

1998; Karpoff, Malatesta & Walking, 1996; Smith, 1996). Inversely, the factors that are believed to facilitate the functioning of shareholder activism as a means of corporate governance include: ownership concentration and the degree of institutional ownership – which both decrease transaction costs and collective action problems for obvious reasons, on the one hand, and the absolute size of the equity holding in the target firm, on the other. The latter is true because a straightforward cost-benefit analysis shows that it makes good sense for shareholders to actively intervene in portfolio companies more or less independent of what other shareholders will do. Say that one owns 1000 shares valued € 5 a piece, while the total costs of intervention are € 50 and the share price after intervention turns out to be € 5,10. Then investing in shareholder activities seems to be a solid investment with a return on investment of 100%. Of course this assumes activism to be successful, and it is questionable whether this is always true as a matter of fact (see below).

Because the factors that are believed to burden shareholder activism are abundantly present in many jurisdictions, and because alternative means of corporate governance – e.g. board monitoring or the market for corporate control – are commonly held to be both cheaper and more effective, shareholder activism is often claimed to make little sense, except under conditions that are either very specific (e.g. Romano, 2001) or that apply only “*in extremis*” (Easterbrook & Fischel, 1991:66). According to this view, shareholder activism is best seen as an *ultimum remedium* that should be put to use only after a thorough cost-benefit analysis and under highly specific conditions that will be relatively rare as a matter of fact (Romano, 2001). And if shareholder activism is efficient only in rare cases, the actual prevalence of shareholder activism may say very little about its true value as a means of corporate governance. This is for reasons similar to the reasons why the number of civil rights lawsuits in a given jurisdiction may say very little about the importance of civil rights in that jurisdiction. Ultimately, it is the availability of the option of shareholder voice, rather than its actual exercise, that matters most.

#### **Empirical research on the performance consequences of shareholder activism**

Because shareholder activism is predominantly understood as a means to secure the end of shareholder wealth maximization, the bulk of empirical research on shareholder activism has in some way or form addressed the activism-performance relationship (for reviews, see: Black, 1998; Gillan & Starks, 1998; Karpoff, 2001; Romano, 2001). The available empirical research is mostly about shareholder activism in the United States and provides a mixed bag of results. On the one hand, there are those that find some positive effect of shareholder activism on targeted firms (Becht et al, 2006; Bijzak & Marquette, 1998; Carleton, Nelson & Weisbach, 1998; Del Guercio & Hawkins, 1999; Opler & Sobokin, 1997; Smith, 1996). On the other hand, a roughly equal number of studies conclude that shareholder activism has a negligible impact on target firm performance (Gillan & Starks, 2000; Johnson & Shackell, 1997; Wagster & Provost, 1996; Wahal, 1996; Woods, 1996).

Karpoff (2001) attributes the conflicting findings on the activism-performance relationship largely to the different methodologies and measures used in empirical studies of shareholder activism. He concludes that in spite of the apparent disagreement on the performance consequences of shareholder activism, a relatively clear picture can be seen to emerge once the different measures for success of shareholder activities are accounted for. On the one hand, the studies that find no or negligible effects typically focus on firm value increases or other measures for corporate financial performance (e.g. Daily et al, 1996; Gillan & Starks, 2000; Johnson & Shackell, 1997; Karpoff, Malatesta, and Walkling, 1996; Smith, 1996; Provost & Rao, 2000; Tsui, 2001; Wagster & Provost, 1996; Wahal, 1996; Woidtke, 2000; Woods, 1996). The studies that find positive effects, on the other hand, tend to take management or governance changes as an indicator for the success of shareholder activism (Bijzak & Marquette, 1998; Carleton, Nelson & Weisbach, 1998; Del Guercio & Hawkins, 1999; Huson, 1997; Martin, Kensinger & Gillan, 2000; Smith, 1996; Wu, 2004).

In Karpoff's (2001:11) view, two generalizations summarize what is presently known about the performance consequences of shareholder activism. The first is that there is no evidence indicating that shareholder activism has

any notable positive effect on firm value or financial performance. The second is that shareholder activism nevertheless can be seen to “prompt small changes in target firms’ governance structures” (2001:2). Although these two generalizations are telling and robust, insight is gained by unpacking these general trends in more specific observations.

#### **Shareholder induced corporate governance reforms and firm performance**

One interesting observation already results from simply confronting the two generalizations identified above. Apparently, shareholder induced corporate governance changes do not result in an increase in firm value (measured as share value) or financial performance (accounting based profit measure). This may be first, because there may be no clear relationship between corporate governance and firm value to begin with. This issue is currently contested in the literature. Although research by Gompers, Ishii and Metrick (2003) finds a positive relationship, this finding is (partly) challenged by research from Larcker, Richardson & Tuna (2005) and Core, Guay & Rusticus (2006).

More interesting for the present venture, second, are explanations for the lacking relationship between shareholder induced corporate governance changes, on the one hand, and firm financial performance, on the other. According to Romano (2001), the fact that no such a relationship presently exists is mostly explained by the fact that the kind of corporate governance changes that are typically sought after by investors, are not found to have a positive relationship with firm value to begin with. More specifically, Romano argues that board structure reforms, executive compensation and confidential voting “have not found to be value enhancing corporate governance devices”, while the performance consequences of rescinding anti-takeover devices are at best ambiguous (Romano, 2001:191). This raises the question why shareholder activities have been aimed at these apparently inconsequential corporate governance changes to begin with? We will address that question briefly below.

#### **Different kinds of shareholder activities**

A second more fine-grained observation pertains to the performance consequences of different kinds of shareholder activities. While shareholder activism in general was not found to have any notable positive effect on corporate value or financial performance, this does not mean that the same result applies to all shareholder activities. As explained above, shareholder activism must be understood as consisting of a wide variety of activities and does not just comprise the right to vote at general meetings, even if this is about the only formal control right shareholders have in public firms. Shareholder activism has been known to include activities as diverse as: information gathering on portfolio companies, visiting general meetings, asking questions at general meetings, submitting proposals to general meetings, voting at general meetings, engaging in either public or private communications with other shareholders or managers of portfolio companies, and many other activities that are presumably fruitful in the pursuit of changes in the governance, management or performance of portfolio firms.

If we account for the different forms that shareholder activism may take in assessing its performance consequences, it seems that contrary to publicly submitting proposals at general meetings, private engagement of portfolio companies or announcing negotiated settlements with portfolio companies often does have a positive effect on firm value or financial performance (e.g. Becht et al, 2006; Chritchly, Hudson & Jensen, 1998; Opler & Sobokin, 1997; Smith, 1996; Strickland, Wiles & Zenner, 1996). Romano (2001:213-219) explains the differential performance effects of public proposals and private engagement both from the content of the proposals – which typically do not involve value enhancing changes (see above) – and from the different signals that public proposals and private settlement announcements convey to the market about the quality of management. Whereas in her view, announcements of negotiated settlements convey the message that management is sufficiently responsive, public proposals communicate precisely the opposite, especially if the same proposals are resubmitted at later meetings. Hence it may not be the difference between public and private dimensions of shareholder activism that accounts for these differential performance effects, but rather the information about managerial

quality that such announcements signal to a market in which information on the quality of management is not readily available.

#### **Which firms are targeted by activist shareholders?**

Another interesting empirical issue that is easily lost in the dominant focus on the activism-performance relationship involves the selection of target firms for shareholder activities. Given that shareholder activism is to be understood as an instrument of corporate governance in the pursuit of shareholder wealth maximization, it can reasonably be expected that firms targeted for activism by shareholders have relatively lower stock values or financial performance than firms that are not targeted, as there will be ample room to improve the performance of such firms. Moreover, the conventional wisdom regarding the functioning of shareholder activities as a corporate governance instrument holds that shareholders will target only those firms where they expect their activities to have a reasonable chance of success. As explained above, the conditions that presumably increase the chance of success include the level of institutional ownership and the size of the absolute shareholding, while the degree of insider ownership is expected to have a negative impact on the chance of success.

The empirical research on target firm selection once more shows a mixed bag of results that again seem to depend to an important degree on the kind of measures used for poor performance (for a review see: Karpoff, 2001). Yet in spite of these methodological issues, the general trend can be seen to be that targeted firms are relatively large (this being an indicator for the absolute size of the shareholding), relatively poor performers (as measured by either prior stock returns or a variety of accounting measures), have a relatively high institutional ownership, while simultaneously displaying a relatively low degree of insider ownership (Romano, 2001). These findings therefore more or less confirm the conventional wisdom regarding the selection of target firms for shareholder activities.

#### **Antecedents of institutional investor activism.**

The last three decades of the former century have witnessed a tremendous increase in the number of institutional investors (Useem, 1996). These include: public pension funds, private pension funds, mutual funds, insurance companies, banks, hedge funds and private equity funds. As a result, the degree of ownership concentration in public firms has risen substantially, which, according to conventional wisdom and the available empirical evidence, facilitates shareholder activism because it increases the chance of success (Brown, 1998). An interesting issue, therefore, involves the question which factors determine the activism of institutional investors. Although not much empirical research is available, Ryan & Schneider (2002) provide a nice review of what we presently know, while simultaneously detailing relevant predictions.

They predict, first, that larger investors will be more active. This is not just because it may indicate the absolute size of an equity holding in a portfolio company but also because economies of scale (Black, 1992; David, Kochhar & Levitas, 1998) enable large investors to develop the relevant expertise and capabilities.

Ryan & Schneider (2002:360) expect, second, that the longer the investment horizon of a given institution will be, the more active an institutional shareholder will become. It should be clear that the presumed benefits of investor activism materialize with a time lag, thereby making activism an increasingly insensible option the shorter the investment horizon becomes. Inversely, the more patience an investor can afford with a given equity holding, the higher the chance that its activism will result in the sought after changes (Brown, 1998).

As we explain below, third, institutional investors are sometimes driven by motivations other than shareholder wealth maximization. This can be for roughly two reasons. First, asset managers may be sensitive to interest other than those of the beneficiaries. This is the case, for example in banks or insurance companies that may have portfolio companies among their clientele and that are therefore more sensitive to pressure from these companies not to engage in shareholder activities (Brickley, Lease & Smith, 1988). But activism may also be the result, second, of social and political pressures to address other objectives than shareholder wealth alone (Romano, 1993; Smith,

1996; Wahal, 1996). While the first kind of pressure sensitivity is assumed to stifle incentives to become active on some portfolio companies, the susceptibility to social and political pressures to become active may result in activism that deviates substantially from the patterns and predictions we describe in this research (see below).

Although Ryan & Schneider (2002:562) also address legal restraints, fourth, they focus exclusively on the United States (Bethel & Gillan, 2002). This makes it difficult to formulate predictions that apply across the board. In general, however, legal restraints involve all kinds of barriers to proxy voting – particularly to cross-border voting – and increased liabilities resulting from shareholder activities. Because legal issues can be a serious impediment to shareholder activities, we dedicate the whole next section to legal issues that arise in the Dutch context.

Fifth, because a large fraction of institutional investors involve pension funds, it is interesting to take a closer look at these investors more specifically. Pension funds roughly have two kinds of obligations towards their beneficiaries. They may have defined-contribution pension plans, in which case only the contributions asked of beneficiaries are fixed and the benefits are contingent upon returns on investment. Alternatively they may have defined-benefit plans which result in fixed obligations to beneficiaries while the contributions may vary in order to balance fund revenues and spending. Ryan & Schneider (2002: 562-563) argue that because asset managers of defined-benefit plans want to avoid asking members for higher contributions, such plans create larger incentives for them to become active on their investments (see also: Provost & Rao, 2000).

A sixth factor they conjecture to influence the degree of investor activism involves the fraction of the total investment portfolio that is passively rather than actively managed. The larger this fraction, the more activities a shareholder is expected to undertake. This is first and foremost because active portfolio management is presumably a substitute for shareholder activism as a means of corporate governance (Gillan & Starks, 2000; Minow & Monks, 1991; Pozen, 1994; Romano, 1993), which explains their inverse relationship (see above). At the same time active portfolio management may also say something about the time horizon of investors, which, according to conventional wisdom, is negatively related to the degree of investor activism (see above).

A seventh factor that presumably determines the degree of investor activism involves the degree to, and manner in which, asset management is outsourced to external parties. Ryan & Schneider (2002:563) expect this third party to become more active with higher outsourcing, because this is expected to increase the absolute size of equity holdings in a portfolio (with this third party presumably owning shares for different outsourcing parties) and because this increases expertise and capabilities due to the resulting specialization and economies of scale (We expect a similar logic to apply to the phenomenon of share lending, in which shares are lent to a third party for a variety of reasons). Yet they simultaneously claim that this also increases the shareholder activity of the outsourcing party on account of outsourcing asset management making it easier to avoid conflicts of interest and insider trading issues which are believed to burden investor activism (Ryan & Schneider, 2002:563-564). Following a similar logic, they additionally predict that retaining voting rights in spite of outsourcing portfolio management may signal an activist stance. In such cases the retention of such rights becomes some sort of proxy for a commitment to activism. Although these hypothesis seem difficult to combine in a single explanatory scheme, it is ultimately an empirical matter whether or not these conjectures are compatible.

#### **How rational is shareholder activism?**

The question was raised why institutional shareholders aim their activities on corporate governance changes that are not found to be value enhancing? In general, it is something of an enigma why shareholder activism has become such a widespread phenomenon in advanced market economies (e.g. Davis & Thompson, 1994; 1997), in spite of the conventional wisdom that it will only be an efficient instrument of corporate governance under relatively unusual conditions, on the one hand, and the cumulating empirical evidence that shareholder activism does not seem to have a notable effect on firm value, on the other.

One answer is that shareholder activism may be motivated primarily by reasons other than the instrumental one of enhancing firm value or financial performance. These alternative reasons may involve either the agency problems that burden investors themselves – with asset managers having different objectives than the beneficiaries

of their asset management activities (Brown, Harlow & Starks, 1996) – or social and political pressures to which particularly institutional investors seem increasingly subjected (e.g. Davis & Thompson, 1994; Graves & Waddock, 1994; Johnson & Greening, 1999; Romano, 1993; Smith, 1996; Wahal, 1996). It should be clear, however, that to the extent that shareholder activism is prompted by social or political pressure on behalf of non-shareholding corporate constituencies – such as labor (Schwab & Thomas, 1998) – or issues that concern the environment or society at large (O’Rourke, 2003), it will conflict fundamentally with the instrumental understanding of shareholder activism that we subscribe to here and that is also dominant in the literature. Arguably, understanding shareholder activism as the result of social or political pressures rather than as a means in corporate governance would require a reconceptualization of the phenomenon.

Ironically, however, this is also true when the degree of shareholder activism is explained from social and political pressures that aim to promote shareholder activism itself. In many jurisdictions, such pressures have led to the enactment of laws or corporate governance codes that present activism by institutional investors either as a fiduciary obligation to beneficiaries, or as a socially desirable activity that produces a public good in a world in which alternative corporate governance mechanisms – such as the market for corporate control in continental Europe – function al but perfectly. It should be clear, however, that that promoting across the board shareholder activism as a matter of public policy defies any rational approach to shareholder activities, as a rational approach would dictate a highly selective use of this corporate governance instrument (Romano, 2001). Because corporate governance issues have been found to defy rational explanations more often, some authors have suggested an alternative ‘institutional’ explanation of corporate governance phenomena (e.g. Zajac & Westphal, 1998).

In general, institutional theory explains the prevalence of organizational forms or features from *symbolic* rather than functional premises (MIZRUCHI & FEIN, 1999; Scott, 2001; Tolbert & Zucker, 1996). It proceeds from the observation that there is often a significant “decoupling” (Meyer & Rowan, 1977) between an adopted organizational form, on the one hand, and its functioning in reality, on the other. The thrust of so-called ‘institutional explanations’ of organizational forms and features is that these may be adopted not so much on account of their instrumental contribution to organizational performance, but rather to create organizational legitimacy with crucial external constituencies (Suchman, 1995). Institutional explanations of corporate governance features and reforms have already been tested and found to be empirically powerful for the adoption of long term incentive plans, share buyback programs and the dissemination of a shareholder value orientation over German firms (Fiss & Zajac, 2004; Zajac & Westphal, 1995, 2004; Westphal & Zajac, 1998, 2001).

An institutional explanation of shareholder activism may involve either cognitive or normative legitimacy. Seen through the lens of *cognitive* legitimacy, shareholder activities are to be understood as an effort to conform to a dominant cognitive logic (Zajac & Westphal, 2004) that pervades financial markets and advanced economies (e.g. Davis & Thompson, 1994). This dominant logic *assumes* that shareholder activism has a positive effect on firm value, more or less independent of whether this is true as a matter of fact. Alternatively, shareholder activism can be understood in terms of *normative* legitimacy when shareholders attempt to comply with societal expectations that pressure shareholders to actively monitor their portfolio companies because this is deemed desirable or even required. In this view, engaging in shareholder activities is simply what shareholders are supposed to do, more or less in the same way that society expects doctors to cure patients even if they have no curative options at their disposal. In our empirical research, we measure these institutional pressures on shareholders through a number of questions in our survey, in order to be able to distinguish the extent to which shareholder activism results from either rational (or functional) or institutional antecedents.



### 3 | LEGAL AND PRACTICAL ISSUES IN SHAREHOLDER ACTIVISM

Shareholders who wish to vote at a general meeting of shareholders have to comply with legal requirements and they might also face additional restrictions exercising their votes. This chapter of the report sets out those requirements as well as the possible impediments a shareholder might experience when trying to vote. In doing so we are limited by the following: Dutch company law (Book 2 Dutch Civil Code) is applicable to Dutch companies who have their statutory seat in the Netherlands even if they may be listed abroad. A foreign listing usually means that the Dutch company also has to comply with the listing rules of the particular stock exchange its shares are listed at.

Foreign companies who have a listing on Euronext Amsterdam have to comply with Dutch listing rules. The company law regime applicable to these companies usually is that of the country they were incorporated in and/or the law of the country in which they have their statutory seat. We limit the legal part of our survey to Dutch institutional investors who vote in the Netherlands but may from time to time take into account foreign institutional investors who vote in the Netherlands.

#### **‘Structuurregime’ (Structured regime)**

Dutch law has recently been adapted to the changing views on shareholders rights. These changes aim to give shareholders more influence on the policy making of the company they hold shares in. We recall that some thirty years ago the structured regime was introduced in Book 2 Dutch Civil Code, based on the view that a company belongs to its stakeholders. Only companies with a certain issued capital (€ 16 million at the moment), a minimum of one hundred employees in the Netherlands and a works council, have to incorporate this structuurregime into their articles of association. As a consequence of the structured regime the balance of power shifted from the general meeting of shareholders to the supervisory board. Important decisions such as the appointment and dismissal of members of the management board and approval of the annual accounts were taken by the supervisory board. The supervisory board appointed (and dismissed) its members. Discussions and reports on corporate governance as well as a growing awareness that shareholders should be given more rights encouraged Dutch government to make some changes to the structured regime and also introduce voting rights for holders of depository receipts.

One important change that was recently made to Book 2 of the Dutch Civil Code as a result of the Tabaksblat code, a corporate governance code which has been effective since 2004, has been made to article 158 Book 2 Dutch Civil Code. Supervisory board members are now no longer appointed by the supervisory board but by the general meeting of shareholders. This change should give (a majority) of shareholders some actual influence on the company’s policy as the supervisory board still appoints (and dismisses) members to the management board. As a result, shareholders are able to (be it indirectly) influence the company’s policy.

The recent verdict of the Enterprises Chamber of the Court of Appeal in Amsterdam in the Stork case<sup>2</sup> illustrates that also in the Netherlands a board of management cannot ignore the wishes of a majority of its shareholders. Even if the hedge funds Centaurus and Paulson were as yet unable to push through their wish to dismiss the present supervisory board of Stork, the Enterprises Chamber did appoint three additional supervisory board members and gave them special powers which in effect cripple the old supervisory board.

Another change made to Book 2 Dutch Civil Code is that also for companies who are subject to the structured regime approval of the annual accounts should be given by the general meeting of shareholders and no longer by the supervisory board.

<sup>2</sup> *Ondernemingskamer Gerechtshof Amsterdam 17-01-2007, LJN:AZ6440.*

### Other changes caused by Corporate Governance discussions

As a result of the Tabaksblat code some other changes have been made to Book 2 of the Dutch Civil Code. The most important and changes relevant to this report are the introduction of articles 107a, 114a and 118a Book 2 Dutch Civil Code. Article 107a gives the shareholder's meeting the right to approve management decisions which may lead to an important change in the identity of the company such as (in any case), (i) the transfer of a large part or the entire company, (ii) the company or its subsidiaries entering into or terminating a longstanding cooperation with a third party, or entering into (or terminating) an agreement by which the company becomes (or ceases to be) a general partner in a limited partnership (*commanditaire vennootschap*) or a general partnership (*vennootschap onder firma*), provided this partnership is of substantial importance to the company, (iii) acquiring or selling a participation of the company if the value of that participation involves at least one third of the value of the company's assets based on its balance sheet, the most recently approved consolidated balance sheet.

Shareholders holding one percent of the issued share capital or holders of shares which have been admitted to the official listing of a recognized stock exchange, which shares according to the official price list represent € 50 million, have recently been authorised to propose an item for the agenda of a shareholders meeting by the introduction of article 114a Book 2.

The last change made to Book 2 of the Dutch Civil Code which is relevant for this survey is the introduction of article 118a of the Dutch Civil Code. Under this provision holders of depository receipts are entitled to request a power of attorney from the trust office which has issued the depository receipts in order to vote at a general meeting of shareholders. Such a power of attorney may only be denied, if:

- the company is under threat of a hostile takeover;
- the depository receipts from the holder (together with those held by others with which he is acting in concert) represent 25% of the issued share capital of the company or more;
- the issuer of the depository receipts is of the opinion that granting such a power of attorney would be strongly against the company's interests.

### Takeover directive

The bill incorporating the Takeover Directive at one point contained a provision to the effect that a holder of depository receipts could not be refused a power of attorney in the event of a hostile takeover. This provision however met with a great deal of resistance which caused the legislator to delete this provision and not propose any fundamental changes to article 118a Book 2 Dutch Civil Code. It is expected that the bill implementing the Takeover Directive will become law in 2007. If that happens, the Netherlands will finally introduce a mandatory bid. The threshold (for now) has been set at 30% of the votes.

The bill implementing the Takeover Directive also contains certain provisions dealing with protective measures against hostile bids. The Dutch bill contains a voluntary and multiple choice-like arrangement which makes it clear that the Dutch government has not taken a firm stand on the issue of protective measures. It is generally expected however that, with the introduction of the mandatory bid, companies will (have to) make less use of protective measures.

### Voting requirements - introduction

By (Dutch) law the right to vote is considered to be a shareholder's most important right. In practice however this voting right is of less and less importance if and when the company becomes larger and as a result has a larger number of shareholders. A shareholder's most important right then becomes the right to receive dividend. This has encouraged some countries to introduce non-voting shares. Under Dutch law it is not possible to issue non-voting shares, although every now and then a proposal to that effect is made. Dutch law does have something similar to a non-voting share: certificates. Through the process of "certification", legal, but not "economic" ownership of the ordinary shares is transferred to a trust office (Slagter, 1996, p.210). Certificate holders have dividend rights, can freely trade their certificates and are entitled to attend the General Meeting of Shareholders, but they

cannot vote. Instead, the trust office is able to exercise the voting right attached to the shares issued to it. As discussed before article 118a has introduced the possibility for holders of certificates to request a 'voting' power of attorney from the trust office in 'peace time'.

Another basic principle of Dutch corporate law is 'one share one vote'. Although recently some companies have indicated that they are considering to reward loyal shareholders by, for instance, giving them extra voting rights or extra dividend rights, it is not likely that the basic principle of one share one vote will be changed. There are a limited number of possibilities available to ascertain that a certain shareholder has more power than another holding the same number of (voting) shares, but these are not widely used. One method that has been recently used by Royal Dutch/Shell is the creation of shares with a very high par value. As the voting right is directly related to the par value of a share, shares with a high par value come with more voting rights or rather a higher number of votes. If a company issues a limited number of shares with a very high par value to a friendly shareholder, this friendly shareholder may be able to outvote other shareholders at a general meeting of shareholders.

### **Voting requirements - rules**

The general rule is that a shareholder has to be called to a general meeting at least fifteen days prior to the date the meeting is held. In principle the management board and or the supervisory board convene a general meeting and also decide on the agenda. If neither of these boards convene a meeting any shareholder may be authorised by the court to convene a meeting provided he meets certain legal requirements. If a shareholder is authorised to convene a general meeting the court may rule that the meeting may be convened at a shorter notice than the aforementioned period of fifteen days. At the meeting the board of management and the supervisory board should give shareholders any information they request except when providing such information would be contrary to the (important) interests of the company. Whether any individual shareholder has the right to ask questions at the meeting and more importantly demand an answer to that question is in debate. There is general consensus however, that if a question from an individual shareholder is supported by the (majority of) the general meeting the question should be answered unless the exception mentioned before is applicable.

Every shareholder has the right to attend a general meeting of shareholders, either in person or by way of issuing a written power of attorney, voice his opinion at that meeting and vote. The articles of association may contain certain limitations as to the possibilities of being represented at the meeting by way of issuing a power of attorney. Again in principle, a shareholder is entitled to vote solely in his own interest and is also allowed to vote even if he has interests contrary to those of the company.

In order to actually vote at a meeting, a shareholder needs to provide 'proof' of his shareholding. This proof may be given by the institution administrating the shares. Also, the articles of association may require that the shareholder gives his shares into custody with a specified custodian. If this is the case the notice calling the shareholder to the general meeting should stipulate exactly where and when this should be done. The articles of association may require the shareholder to fulfil other obligations before allowing him to vote at a general meeting of shareholders.

### **Voting requirements - record date**

Article 119 Book 2 Dutch Civil Code allows for articles of association of a company to stipulate that only those shareholders are allowed to vote who have been registered as such at least thirty days before the meeting. This is called a registration or record date. Setting a record date is done to facilitate the communication between the company and its shareholders, between shareholders, as well as to encourage proxy voting. Prior to the 1st of January 2007 the record date was set at seven days. The new law has extended the period to thirty days.<sup>3</sup> The same law deals with electronic voting, a subject that will be discussed in the following paragraph.

Setting the record date at thirty days prior to the taking place of the actual meeting has an effect on the duty of

<sup>3</sup> Law of 20 October 2005, (Stb 525) changing Book 2 Dutch Civil Code to encourage the use of electronic means in the decision making process of legal entities.

both the management board as well as the supervisory board to provide shareholders with adequate information enabling them to cast their vote in a properly informed and well balanced manner. This means that the provisions in Book 2 Dutch Civil Code dealing with the calling of a shareholders meeting as well as those demanding that shareholders and the supervisory board should be provided with information regarding the agenda at such a time that the information is of actual use, may have to be changed. For instance, at the moment article 115 Book 2 Dutch Civil Code states that a meeting should be convened at a minimum of fifteen days prior to the meeting. Also the information which forms part of the agenda has to be available at or around such a time. If for instance the approval of annual accounts is on the agenda, those accounts should be made available to the shareholders at a reasonable time before the record date. All this affects the organization of the company and the opportunities for shareholders to be well prepared for the shareholding meetings. It is generally believed that setting the record date at thirty days prior to the meeting will positively affect the willingness of institutional shareholders to exercise their voting rights.

### **Electronic voting**

As said before the new law which has come into force on 1st January 2007 also relates to electronic voting. The law is meant to facilitate and encourage the use of electronic means (email and/or internet) when voting at and before a shareholders' meeting. It allows for a company's articles of association to stipulate:

- that electronic means may be used when sending out notices of a shareholders' meeting,
- that shareholder may participate at a meeting by way of electronic means, and also
- that shareholders are entitled to vote electronically before, during and outside of a general meeting.

The law does not, however, impose a legal obligation for companies to facilitate the use of electronic means of communication nor does it force shareholders to use those electronic means. The law is restricted to facilitation of the use of electronic means of communication between shareholders and the company or between shareholders as such. As yet, live electronic voting (meaning: being present at the meeting through electronic means, listening to and participating in the debate, and being able to actually vote at that time) at shareholders meetings does not take place. However, more and more listed companies facilitate the issuing of proxies by electronic means which allows for easier participation by shareholders both in as well as outside the Netherlands.

### **Impediments to voting**

Whether a shareholder is an active shareholder or not depends on a number of circumstances. These range from the shareholder not having any interest in the corporate policies of the company he invests in, to the shareholder experiencing legal or other impediments to his active participation in the company. The survey tries to identify the most important legal impediments a shareholder might experience when trying to vote his shares. Below we will set out the rules and regulations existing under the laws of the Netherlands which a shareholder might encounter when trying to vote the shares he holds in an institution listed on Euronext Amsterdam.

In the survey we have addressed five main categories of impediments:

- voting agreements;
- acting in concert;
- stock lending;
- corporate governance/shareholder rights directive;
- electronic voting.

### **Voting agreements**

Under Dutch law a shareholder may enter into an agreement whereby he agrees to vote according to certain instructions. This is often done in joint venture situations.

Voting agreements come in many varieties. The one element they have in common is that a shareholder commits himself to exercising (or not to exercise) his voting rights in a certain manner. Three different types of voting agreement may be defined:

- a. Between the company and a shareholder. A shareholder may commit himself to vote in accordance with certain instructions from management and/or the supervisory board. This kind of agreement is forbidden under Dutch law because it violates the overriding principle of the separation of the various corporate bodies within the company. This means that these corporate bodies have their own rights and obligations and need to be able to independently make decisions;
- b. Between shareholders;
- c. Between shareholders and third parties.

Categories b and c are not only permissible under Dutch law but are also used in the Netherlands. In the twentieth century some doubts were cast over the question whether voting agreements of the categories b and/or c were valid. The main argument was that a shareholder would act in violation of the interests of the company if he would enter into such a voting agreement. In 1944 the Dutch Supreme Court (Court of Cassation) ruled that the voting agreement whereby two shareholders who each held 50% of the issued share capital had agreed to vote in accordance with the advice given by a third party in a deadlock situation, was valid.<sup>4</sup> The Supreme Court has upheld this view in a number of other cases.<sup>5</sup> The Supreme Court has ruled that a shareholder is at liberty to exercise his voting right in any way he deems fit (within the general principle of reasonableness and fairness).

Evidently, a voting agreement which tries to frustrate a legal or statutory requirement is null and void.

Also a voting agreement that causes the more or less permanent transfer of a shareholders' voting right is deemed to be null and void. The reason being that a shareholder should always be able to exercise his voting right more or less independently, he should be able to make up his own mind. This means that a.o. the agreement whereby a shareholder more or less 'sells' his voting right may be nullified. This is a somewhat different situation than (stock) lending which will be discussed below.

One of the important questions relating to voting agreements is whether a shareholders' vote is valid when that vote has been cast in violation of a voting agreement. The generally accepted doctrine is that the vote is valid even if it has been cast contrary to a voting agreement. From a practical point of view this does make sense. If votes may be nullified when they are cast in violation of a voting agreement this could mean that certain corporate resolutions would have to be 'turned back', because the required quorum has not been met. This could lead to a great deal of uncertainty and would eventually limit the company's actions.

Occasionally a party requires an irrevocable proxy from the other party before entering into a voting agreement. This kind of proxy is generally felt to be valid as long as the proxy is meant to ascertain that a certain action is being taken which is in the interest of the issuer of the proxy or a third party. Even when a shareholder has given an irrevocable proxy to a third party he is not prevented from attending the general meeting himself and casting his vote at that meeting. Obviously, the proxy holder is not allowed to vote in such a case.

#### **Acting in concert**

On 21 April 2004, the 13th Directive (Takeover Directive) was adopted by the EU. This Directive is designed to further the goal of harmonization of the takeover rules in the EU.

The Directive provides that shareholders who obtain control over a listed company will have to make a mandatory offer to other shareholders. Control is present, in respect of a N.V., if a person obtains, either directly or indirectly (e.g. via other legal persons), "substantial control" (at least 30% of the voting rights in a general meeting of shareholders) over an N.V.

Voting rights of parties, with whom the controlling party can act in concert, also count in this threshold. Such acting in concert has to be aimed at obtaining substantial control or thwarting an announced takeover of the

<sup>4</sup> HR 30 juni 1944, NJ 1944, 465 (*Wennekes/Van Neck*).

<sup>5</sup> HR 13 november 1959, NJ 1960, 472 (*Distilleerderij Melchers*) and HR 19 februari 1960, NJ 1960, 473 (*Aurora*).

company. The basis of this objective must take the form of an agreement, not necessarily in written form. Oral agreements may be sufficient to establish such agreement. The Bill provides for a presumption of acting in concert in respect of some relationships (e.g., if shares are held by group companies, partners or relatives). Substantial control may be obtained not only by the acts of the person himself acquiring such control. This may also arise through the shareholding of a party with whom such person acts in concert. In addition, third-party behavior may also lead to substantial control. Acting in concert is also dealt with in the rules regarding the notification of major shareholdings. Section 10 of the Transparency Directive<sup>6</sup> has been implemented in article 5:45 Act on Financial Supervision and now provides that a shareholder should add to his own voting rights the voting rights held by a third party with whom the shareholder has concluded an agreement which obliges them to adopt, a lasting common policy towards the issuance of their voting rights.

Hence, when engaging in shareholder activities, shareholders should be careful not to abuse market rules. At the same time however, Dutch and other corporate governance codes encourage institutional shareholders to join forces with other shareholders and collectively address relevant governance issues. The general feeling is that the current regulations are not clear enough specified to answer the key questions when shareholders abuse market rules and 'act in concert'. This situation might prevent certain shareholders from voting or engage in other shareholder activities.

### Stock lending

The lending of securities and especially of common shares is an increasingly important practice which, generally speaking, should improve market liquidity. The word lending, however, has misled many as in law the transaction is in fact an absolute transfer of title against an undertaking to return equivalent securities. Misconceptions as to its nature have led to loss of shareholders votes in important situations as well as to cases of shares being voted by parties who have no equity capital at risk in the issuing company, and thus, no long-term interest in the company's welfare. Corporate governance policies of lenders may also be undermined because of a lack of coordination with lending activity. It is also imperative that there be as little risk as possible that a poll of the shareholders may be compromised through a misuse of the borrowing process. To address these concerns, the International Corporate Governance Network ('ICGN') has proposed the 'ICGN Stock Lending Code of Best Practice' to its members in 2005.<sup>7</sup> One of the main problems of these principles lies in applying them thoroughly. Staffers or agents responsible for voting and investment decisions should always have full transparency whether and what percentage of shares has been lent. Beneficiaries should always know which percentage their manager has voted of its position in a given company. Consistency may be lost when a lender with a policy to recall shares to vote 'on important issues' can not know in a particular country with an early record date what the issues to be voted upon will be. An uncertain situation may arise when lenders, drawn by a sudden rise in demand, lend shares under circumstances in which it is highly probable that they are being borrowed in order to alter the result at a shareholders' meeting.

Also under Dutch law, when entering into a lending agreement, the lender transfers legal ownership to the other party, the lender does retain economic ownership. Again, the word lending is therefore misleading: legal ownership is being transferred. The only way a lender may protect his rights is with the borrower, he has no right with the issuer of the shares that have been lent. Most economic rights of the lender may also be preserved through contractual agreements with the borrower. The rights involving the issuer, however, such as the right to vote, can *not* be preserved in any way. If an investor wishes to vote its lent shares or protect its legal interests as a registered shareholder, he must recall the shares. This is the reason lending agreements may have a provision to the effect that upon request the borrower will transfer the shares back to the lender, usually to enable the lender to vote the shares. If the borrower and the lender enter into a voting agreement whereby the lender votes the shares of

<sup>6</sup> Directive 2004/109/EG.

<sup>7</sup> To be downloaded from [www.icgn.org](http://www.icgn.org)

behalf of the borrower, failure of the lender to vote in accordance with the instructions in the voting agreement should be treated as a breach of contract as set out above.

If the stock lending agreement contains a so called 'buy back' option for the borrower and the lender fails to transfer the shares back, this should –in our opinion – also be qualified as a breach of contract. Under present Dutch law this breach of contract does not invalidate any votes the lender has cast after failing to return the shares to the borrower.

#### **Corporate Governance/ Shareholders' rights directive**

The Commission's Action Plan on modernizing company law and enhancing corporate governance in the European Union recognized that improving the rights of shareholders of companies across the Member States was a priority. Two public consultations were launched in September 2004 and May 2005 with a view to proposing a directive on shareholder's rights. Respondents to both consultations supported the introduction of minimum standards at EU level for the organization of general meetings and the exercise of shareholders' rights. Results of these consultations are available at: [http://europa.eu.int/comm/internal\\_market/company/shareholders/index\\_en.htm](http://europa.eu.int/comm/internal_market/company/shareholders/index_en.htm)

After having carried out a comprehensive impact assessment of these consultations, the Commission proposed a directive that should ensure in particular that shareholders have timely access to the complete information relevant to general meetings and that the exercise of the voting right by correspondence and by proxy is facilitated. Furthermore, the proposal provides for share blocking and related practices being abolished which represents a major obstacle to voting in particular for institutional investors. On average, about one third of the share capital of EU listed companies is held by non-residents. Key obstacles to voting faced by non-resident shareholders include share blocking, insufficient or late access to information, and overly burdensome requirements on distance voting. In January 2007 a compromise was reached between the European Commission, the European Council and the European Parliament. The text below is based on this compromise.

The proposal sets the following minimum standards which would eliminate the main obstacles in the cross-border voting process and enhance certain other rights of shareholders. (1) General Meetings should be convened not later than on the twenty-first day before the day of the meeting. However, each Member State shall ensure that at least eight days elapse between the convocation date and the record date. All relevant information should be available from the convocation date onwards, and posted on the issuer's website. The notice should contain all necessary information. As indicated before, under Dutch law shareholder's meetings may be convened with at least fifteen days notice (except when the notice period has been decided upon by a court). This convocation date has to be changed for listed companies (2) Share blocking should be abolished and replaced by a record date which should be set no earlier than 30 days before the meeting. Member States shall ensure that a single record date applies to all listed companies. As set out before Dutch listed companies can opt for a record date at thirty days. (3) The right to ask questions should be accessible to non-residents. The maximum shareholding thresholds to benefit from the right to table resolutions should not exceed 5%, in order to open this right to a greater number of shareholders while preserving the good order of general meetings. The right to ask questions at a general meeting is a right any shareholder has under Dutch law. The board of management and/or the supervisory board is under the obligation to reply if the question is supported by the general meeting and if answering the question is not contrary to an important interest of the company. Already shareholders holding a minimum of 1% of the issued share capital are entitled to table resolutions. (4) Proxy voting should not be subject to excessive administrative requirements, nor should it be unduly restricted. Shareholders should have a choice of methods for distance voting. Dutch law allows for electronic voting to be made possible by the company's articles of association. For now, there is no legal obligation for a company to make electronic voting possible. (5) Voting results should be available to all shareholders and posted on the issuer's website. At this moment, Dutch law does not require voting results to be made public.

**Electronic voting**

As mentioned previously, the law does not impose a legal obligation for companies to facilitate the use of electronic means of communication nor does it force shareholders to use those electronic means. It is restricted to facilitation of the use of electronic means of communication between shareholders and the company or between shareholders as such. Although live electronic voting (meaning: being present at the meeting through electronic means, listening to and participating in the debate, and being able to actually vote at that time) at shareholders meetings does not take place, an increasing number of listed companies facilitate the issuing of proxies by electronic means which allows for easier participation by shareholders both in as well as outside the Netherlands.

## 4 | EMPIRICAL STUDY

### 4.1 Research design, sampling and response

In this section we provide a brief overview of the research design, the sampling procedure and the response to our questionnaire.

#### Desk research and interview protocol

To study governance practices of institutional shareholders, we decided on a research design that included three main steps. First, we conducted a survey of the available literature on governance practices of institutional shareholders in order to identify the main issues in the field. This desk research provided the input for the construction of a protocol for semi-structured interviews with representatives of a number of prominent Dutch institutional investors, which constituted the second step of our research design. The results of both the literature review and the interviews, third, enabled us to develop a questionnaire, which we sent out to 2326 institutional investors in 8 different countries.

#### Semi-structured interviews

The interviews took place in March and April 2006. The selection of our interviewees happened in close consultation with the monitoring group that Eumedion put together to supervise this research project. The main idea behind the selection procedure was to select the most knowledgeable informants from a diverse variety of institutional investors in order to survey the full scope of issues that investors are confronted with. Altogether, we interviewed 12 informants who were mostly asset managers and sometimes the chief (legal) officer in charge of corporate governance or shareholder activities. The institutions that our informants represented included: public pension funds, private pension funds, banks, insurance companies, and mutual funds. An overview of our informants and the financial institutions they represent will be provided.

On average, the interviews lasted about 70 minutes. The interviews followed a semi-structured protocol, meaning that the researchers were guided by a broad – yet systematic – list of topics rather than a detailed set of questions. As explained above, this list was obtained through the literature review and subsequently validated and, where necessary, complemented by the monitoring group. During the interviews the researchers probed the answers they were given until no new information was disclosed anymore. In addition, the informants were given sufficient opportunity to raise and discuss issues that were either not anticipated by the protocol, or that they felt needed further elaboration or explanation. The interviews were recorded and transcribed after which the transcripts were sent back to the interviewees for validation. This resulted in only minor adjustments.

#### Questionnaire and sampling

Based on the output from the desk research and the interviews we proceeded to design a questionnaire. The idea that guided the survey was to ask a larger group of investors about issues that either the literature or the interviews highlighted as relevant and significant. This ultimately resulted in a questionnaire that incorporates three distinctive parts. The first part is concerned with general questions about the characteristics of the institutions in our sample, their asset management practices, and their general policy regarding shareholders activities. The second part of the questionnaire includes questions about actual shareholder activities of institutions and their motivations for being active in their *home country*. The third part of the questionnaire deals with the same questions, but this time for the country in which the responding institution holds the largest *foreign* equity investments.

The questionnaire was sent to a total of 2326 institutional investors in 8 different countries. These included: Canada, France, Germany, Italy, the Netherlands, Norway, the United Kingdom and the United States. Although

the countries were selected to maximize a variety in legal institutions relevant to corporate governance, they were all highly developed industrialised economies that together constitute a majority share of global equity markets. Within these countries, only those institutional investors were included that could be identified from publicly available sources. This resulted in a sample of 2326 institutional investors that included: banks, insurance companies, financial conglomerates, private pension funds and public pension funds, but which excluded private equity investors.

### Response

Overall, the response to our survey can be said to be low: 4,6 %. The response rate differs, however, for different countries and different types of institutional investors. The highest response is from the Netherlands (16,2%), while the lowest response is from Germany (0,4%). The other countries fall in between, with Canada, Italy, Norway and the UK centering around a 5% response rate. Moreover, the response rate for pension funds is slightly better than for all institutional investors (6,5%), while the response for non-pension funds investors is very low (less than 2%). A low response rate, however, is a fate shared by most survey based research projects nowadays. It does not necessarily mean that the results are of no use. More interesting for that issue is the composition of our sample, to which we turn now.

## 4.2 Characteristics of the institutional investors

In this section we describe the characteristics of the institutional investors included in our sample.

### Sample composition

The composition of our sample is presented in table 1. In all, 107 institutions have returned questionnaire, of which the majority (92) are pension funds, representing 86 % of our response. In addition, 44 or 41% of our response came from the Netherlands, of which 37 or 84% were pension funds. The latter is roughly equivalent with the fraction of pension funds in our sample as a whole.

**Table 1** | *Sample characteristics*

Country	Full sample		Pension funds	
	Number	Percentage	Number	Percentage
Netherlands	44	41%	37	40%
Canada	17	16%	15	16%
France	1	1%	1	1%
Germany	1	1%	0	0%
Italy	6	6%	3	3%
Norway	6	6%	6	7%
United Kingdom	17	16%	17	18%
United States	13	12%	12	13%
Unknown	2	2%	1	1%
<b>Total</b>	<b>107</b>	<b>100%</b>	<b>92</b>	<b>100%</b>

From table 1 it is quite clear that most of the returned questionnaires are from the Netherlands and from pension funds, and that the number of questionnaires from other individual countries and from non-pension fund investors is low. This sets constraints on the kind of analysis we can perform on the data collected. More specifically, we will not be able to say much about specific countries other than the Netherlands, nor about specific kinds of non-pension fund institutional investors. We can, however, meaningfully distinguish Dutch from non-Dutch pension funds, and we will consistently do so below.

### Activities of investors

Table 2 summarizes the activities the institutions in our sample are engaged in. We distinguish five different categories of activities. In addition, we differentiate Dutch from non-Dutch institutions. From this table it can be concluded that the majority (59%) of the Dutch institutions are company or private pension funds, and that the second largest subgroup within the Dutch group consists of public or sector pension funds (25%). This is the other way around for the non-Dutch institutions, where the number of public pension funds (46%) is slightly larger than the number of private or sector pension funds (41%). Other than that, the distributions are roughly similar, with pension funds by far outweighing other types of institutional investors.

**Table 2** | *Activities of institutions*

Type of activity	Dutch institutions		Non-Dutch institutions	
	Number	Percentage	Number	Percentage
Public or sector pension fund	11	25%	29	46%
Company or private pension fund	26	59%	26	41%
Banking services	0	0%	3	5%
Insurance services	4	9%	3	5%
Mutual fund	3	7%	2	3%
<b>Total</b>	<b>44</b>	<b>100%</b>	<b>63</b>	<b>100%</b>

### Kinds of obligations

Because our sample contains a large majority of pension funds, it is interesting to know what kind of obligations these funds have towards their beneficiaries. As explained before (in chapter 3), there are roughly two possibilities. One can either have a *defined benefit* pension plan in which payouts to beneficiaries are largely guaranteed, or one can have a *defined contribution* pension plan in which only the contribution to the plan is fixed and the payouts to beneficiaries are of an open ended nature. Table 3 provides information on the type of obligations the pension funds in our sample have.

**Table 3** | *Type of financial obligation (as percentage of total investments) for pension funds*

Type of obligations	0-20%	20-40%	40-60%	60-80%	80-100%	observations
Full sample: Guaranteed payouts (defined benefit plans)	4	3	3	8	68	86
Full sample: Open-ended (defined contribution)	20	5	4	1	12	42
Dutch pension funds: Guaranteed payouts (defined benefit plans)	0	1	0	4	27	32
Dutch pension funds: Open-ended (defined contribution)	6	2	0	1	4	13
International pension funds: Guaranteed payouts (defined benefit plans)	1	1	2	4	39	47
International pension funds: Open-ended (defined contribution)	11	2	3	0	4	20

From this table it can be concluded that defined benefit plans are the largest type of financial obligation for all pension funds in our sample. For 79% (68/86) of all pension funds in our sample, between 80-100% of their total investments result from defined benefit plans. This is roughly similar for the subgroups of Dutch and International pension funds, with 84% and 83% largely having obligations from defined benefit plans respectively. For a minority of the pension funds in our sample, 80-100% of their obligations derive from defined contribution plans (29%), the fraction being a bit larger for Dutch (31%) pension funds as compared with international pension funds (20%).

### Portfolio composition

Table 4 presents information on the portfolio composition of the institutional investors in our sample. Panel A first reports investments of Dutch and international pension funds. The table reports the mean, median, and quartiles (25% and 75%). A comparison of average and median amounts of equity invested quickly leads to the conclusion that the average numbers are less informative than the median numbers on account of the value of the average

being vulnerable to outliers, in this case a (small) number of very large investors. It is therefore more telling to focus on the median numbers reported in this table.

The median value of the total portfolio invested for Dutch pension funds is € 550 mln. Dutch pension funds invest € 289 mln in public equity. The amount of public equity invested in the home countries (in this case the Netherlands) is € 49 mln, whereas € 172 mln is invested in the single largest foreign country. The median public equity investments in other foreign countries amounts to € 424 mln.

The median amount of investments reported by international pension funds is much higher than those of Dutch pension funds (€ 2.900 mln). The international pension fund's median investment in public equity is € 1.750 mln, of which almost half is invested in their home country (€ 831 mln.). The median international investor's investment in the largest foreign country is € 196 mln, while the median public equity investments in other foreign countries is € 404 mln.

Panel A also provides information on the number of public companies in which pension funds hold equity stakes. The median number of portfolio companies in which Dutch pension hold equity is 276, of which only a median of 15 companies are held in the home country (the Netherlands). The median number of portfolio companies in the largest foreign country and other foreign countries is much higher (100 and 155 respectively). These numbers demonstrate the international investment orientation of Dutch pension funds.

The median number of public companies held by international pension funds invest in is almost twice as large (495) as the number of companies held by Dutch pension funds. In addition, international pension funds also seem to invest more in companies in their home country (137). Moreover, for international pension funds the median number of companies invested in is 105 in the largest foreign country, and 225 in other foreign countries. In sum, the Dutch and international pension funds differ in three dimensions. First, the Dutch pension funds are relatively smaller as measured by the value of assets invested. Second, the Dutch pension funds have a relatively smaller amount of investments in the home country and hence demonstrate a more international investment focus. To a degree this can be seen as the result of the limited investment opportunities available in the relatively small Dutch equity market, but other factors not may also play a role. Third, the international pension funds are relatively more diversified, holding a higher number of portfolio companies in both domestic and foreign equity markets, even though the investment home bias of international pension funds is notably larger than that of Dutch pension funds.

Panel B reports on the portfolio composition of non-pension fund institutional investors. We should point out, however, that the number of observations is rather limited for these investors. As a result, the information provided in this part of the table should be treated with care.

With this in mind, a few observations can be made. First, the median value of the total investment portfolio is higher (€ 6.500 mln) than that of both Dutch and international pension funds. Apparently, these institutions are larger than the pension funds. Moreover, these investors also hold a relatively larger part of their investments in public equity as compared to the pension funds, thereby potentially making them more interesting from the perspective of investor activism. Second, there seems to be more of a home bias for non-pension fund institutional investors in the Netherlands, as almost half (47%) of the investment in public equity is in the domestic market, with the difference between international non-pension fund investors being relatively smaller than the difference between Dutch and international pension funds. A remarkable finding is the number of public companies invested in by Dutch non-pension fund investors (870), as compared to both the Dutch (276) and international pension funds (495), on the one hand, and the international non-pension fund investors (100), on the other. Apparently, Dutch non-pension fund investors are more diversified than their international counterparts, but this observation should be qualified in the light of the small number on international non-pension fund investors in our sample.

Table 4 | Portfolio composition institutional investors

Portfolio composition	Dutch					International				
	Average	25%perc	Median	75%perc	Obs	average	25%perc	median	75%perc	obs
<b>Panel A: pension funds</b>										
Values in mln euros										
Total investment portfolio value	11484	300	550	2900	37	11468	949	2900	7932	55
Investments - public equity	8435	115	289	5150	32	28486	729	1750	6237	41
Investments - public equity - home country	1007	12	49	274	28	3474	282	831	3156	47
Investments - public equity - largest foreign country	3391	30	172	1306	31	3902	108	196	493	45
Investments - public equity - other foreign countries	5234	61	424	3664	26	7960	145	404	966	40
Number of companies/countries										
Investments - public equity	1162	93	276	1509	19	1196	190	495	1006	31
Investments - public equity - home country	20	8	15	24	23	578	60	137	500	37
Investments - public equity - largest foreign country	376	22	100	500	24	297	60	105	363	32
Investments - public equity - other foreign countries	679	71	155	500	22	586	88	225	400	32
Info on largest foreign country	Mainly USA					USA, UK				
Number of other foreign countries	29	10	20	43	23	29	19	25	40	33
<b>Panel B: other institutional investors</b>										
Values in mln euros										
Total investment portfolio value	28243	5600	6500	21500	7	11765	2078	3439	5676	8
Investments - public equity	9713	2175	2850	4650	6	3396	1263	3350	3833	6
Investments - public equity - home country	2584	900	1350	1875	6	2479	592	2104	2975	7
Investments - public equity - largest foreign country	4211	200	300	400	5	667	582	727	813	4
Investments - public equity - other foreign countries	3703	600	1200	1500	5	419	277	419	562	2
Number of companies/countries										
Investments - public equity	1144	445	870	1569	4	224	50	100	380	5
Investments - public equity - home country	36	28	38	40	6	79	50	65	80	6
Investments - public equity - largest foreign country	230	20	80	385	5	150	75	100	200	3
Investments - public equity - other foreign countries	680	100	400	800	5	140	110	140	170	2
Info on largest foreign country	USA/UK					mainly USA				
Number of other foreign countries	31	20	30	45	5	25	25	25	25	1

### Investment horizon

We also asked institutional investors to indicate the average time horizon for investments in public equity (table 5). This might be relevant because shareholder activities decreasingly make sense the shorter the investment horizon, as the benefits of shareholder activism presumably materialize with a time lag.

The average time horizon for Dutch and international pension funds is roughly similar (on average about 42 months with a median value of 36 months). The average time horizon for Dutch non-pension fund investment is somewhat higher (on average about 53 months with a median value of 30 months), while the difference between Dutch and international non-pension fund investors is larger (both median and average are 24 months). Again, the latter must be interpreted with caution on account of the low number of observations for non-pension fund investors.

Table 5 | Average time horizon for equity investments

	Pension funds				Other			
	Dutch		International		Dutch		International	
	Average	median	Average	median	average	median	average	median
Months	41,8	36	42,1	36	52,6	30	24,0	24
Observations	23		33		5		4	

### Securities lending

Finally, we asked respondents about their securities lending practices (table 6). This question was only asked to Dutch institutions. First, we ask whether institutions actually lent shares to third parties. Of the pension funds 62% lent shares, while for the other institutions this percentage is 71%. For the lending institutions we ask what percentage of the portfolio they lent. The results show median percentages of 10% (pension funds) and 25% (other institutions). These findings indicate that lending occurs in many institutions and on a large scale.

Table 6 | Securities lending

	Pension funds		Other	
<b>Did your institution lend shares from your portfolio to third parties over the past 12 months?</b>				
Yes	62,16%		71,43%	
No	37,84%		28,57%	
<b>Observations</b>	37		7	
Estimate of the percentage of the portfolio that was on average lent over the past year				
percentage, average	15,2		31,3	
percentage, median	10,0		25,0	
<b>Observations</b>	20		4	
How frequently did you took the following actions in the past year?				
We recalled lent shares in order to vote on them	2,6	2	1,7	2
We gave instructions to our borrowers how to vote on the shares we lent	1,0	1	1,1	1
We retained all voting rights on the shares we lent	1,2	1	1,2	1
We requested assurances from our borrowers that our instructions have been carried out	1,2	1	1,3	1
We were stricter with our lending activities in The Netherlands than abroad	1,8	1	1,5	1
The general assumption that voting rights pass on to the borrower represented an impediment for us when lending out shares	2,6	3	1,5	1
<b>Observations</b>	23		5	

We also ask the respondents about their actions regarding lending, on a scale of 1 (never) to 5 (almost always). We find that the median score on recalling shares to vote on them is 2, i.e. seldom. The next three items concern the control the lending institutions have over their shares. The median scores are 1, indicating that the median institution never retains voting rights, instructs borrowers or requests assurance on instructions. In our interviews we noticed that share lending is often practiced but little developed. Although some institutions impose maximum thresholds on lending, the 'lending desk' often operates separately from the governance/voting officers.

## 4.3

### Shareholder activities

In this section we report on shareholder activities of the investors in our sample and the resources they dedicate to that purpose.

#### Resources dedicated to shareholder activities

Table 7 provides information on the financial resources institutional investors spent in the last year (2005) on different shareholder activities related to the public equities in the portfolio. On average, Dutch pension funds

spent about € 101.188 of which roughly 82% (€83.077) was spent in their home country, while the international pension funds spent roughly 10% less (€ 89.110) of which only 47% (€ 41.828) was spent in the domestic market. In comparison, therefore, Dutch pension funds seem to display a larger home bias in their activities as shareholders, which is even more noteworthy if we take into consideration the relatively larger international investment focus of Dutch pension funds and their more limited diversification. At the same time, Dutch pension funds spent considerably more in their largest foreign country in which they invest, which seems to suggest a larger concentration of investments for Dutch pension funds in a single foreign market (mainly the United States).<sup>8</sup>

Dutch non-pension fund investors seem to have spent slightly more resources (€ 110.125) on shareholder activities than Dutch pension funds, and also display a smaller home bias (41%) in their shareholders activities. Again, this observation needs to be interpreted with caution on account of the low number of observations in this category, which presumably also explains the zero's we find in the cells for foreign non-pension fund investors.

**Table 7** | Resources dedicated to shareholder activities related to public equity

	Dutch					International				
	Average	25%perc	Median	75%perc	obs	average	25%perc	median	75%perc	obs
<b>Panel A: Pension funds</b>										
Amount (€), Total	101.188	0	0	28.750	30	89.110	0	0	40.820	35
Amount (€), home country	83.077	0	0	25.000	13	41.828	0	3.525	27.832	14
Amount (€), largest foreign country	32.273	0	0	2.500	11	4.042	0	0	0	14
Full time equivalent employees, total	0,5	0,0	0,0	0,4	34	3,7	0,0	0,1	2,0	43
Full time equivalent employees, home country	0,4	0,0	0,0	0,5	15	2,6	0,1	0,4	2,0	22
Full time equivalent employees, largest foreign country	0,2	0,0	0,0	0,5	13	2,0	0,0	0,0	0,4	19
<b>Panel B: Other</b>										
Amount (€), Total	110.125	30.125	70.000	150.000	4	0	0	0	0	2
Amount (€), home country	45.125	22.625	40.000	62.500	4	0	0	0	0	1
Amount (€), largest foreign country	125.000	62.500	125.000	187.500	2					0
Full time equivalent employees, total	1,3	0,5	1,0	1,0	5	4,8	0,5	2,0	4,3	6
Full time equivalent employees, home country	0,7	0,5	0,8	1,0	4	5,2	1,0	2,0	5,0	5
Full time equivalent employees, largest foreign country	1,5	0,5	1,0	2,2	3	1,5	1,3	1,5	1,8	3

In addition to financial resources spent, table 7 also reports the number of full time equivalents (fte) dedicated to shareholder activities on equity investments. For the Dutch pension funds the average is 0,5 fte, though it should be noted that the average is less informative due to some outliers in 75% quartile (0,4 fte). In the case of international pension funds the average number of full time equivalents dedicated to shareholder activities seems notably larger (3,7 fte), but the same qualification regarding outliers applies.

A roughly similar pattern can be observed for the other institutional investors, with these non-pension fund investors generally spending more resources than pension funds (median fte allocated to shareholder activities are 1,0 and 2,0 fte for Dutch and international investors respectively). In this case, however, the Dutch investors seem to have less of a home bias than international investors, even though this result may very well be due to the low number of observations in this category.

In sum, the resources dedicated to shareholder activities that investors report are very small, perhaps even negli-

<sup>8</sup> The numbers of observations for home and foreign country are lower than for total expenditures. Therefore, the results are based on different samples.

gible. This is consistent with previous research. Investigating the shareholder activities of the Californian pension fund CalPERS, Smith (1996:245) estimated the annual cost of its shareholder activities to be about \$ 500.000, or about 0.02% of its domestic holdings. Del Guercio and Hawkins (1999:328) report a similar fraction for TIAA-CREF, which is in line with what activist pension funds in general spend on corporate governance programs (Romano, 2001:225). The trivial amount of resources dedicated to shareholder activities also constitutes a signal that shareholder activities may very well be undertaken for symbolic rather than consequentialist reasons.

### Proxy voting

Table 8 presents the outcome of the questions related to proxy voting and corporate governance services providers. First, we ask what type of proxy voting providers the institutions use to vote their shares.

**Table 8 | Proxy Voting**

	Pension funds		Other	
	Dutch	International	Dutch	International
<b>What type of proxy voting providers do you use to vote your shares?</b>				
Only local proxy voting provider(s)	8%	19%	14%	0%
Only global proxy voting provider(s)	30%	17%	43%	17%
Both local and global proxy voting provider(s)	16%	31%	0%	0%
None	46%	33%	43%	83%
<b>Observations</b>	37	54	7	6
<b>What type of corporate governance services provider(s) do you use to gather information about your portfolio companies?</b>				
Only local governance services provider(s)	11%	22%	0%	14%
Only global governance services provider(s)	16%	13%	29%	14%
Both local and global governance services provider(s)	24%	24%	14%	14%
None	49%	41%	57%	57%
<b>Observations</b>	37	54	7	7
<b>Do you sometimes give proxies to fellow shareholders?</b>				
Yes	16%	8%	71%	14%
No	84%	92%	29%	86%
<b>Observations</b>	37	52	7	7

Almost half of the Dutch pension (46%) funds use no proxy voting provider at all, 8% uses only local proxy voting providers, 16% uses both local and global services, while 30% percent uses only global proxy voting providers. In contrast, only about a third of the international pension funds do not use any proxy voting services at all, followed by 17% that uses only local providers, 33% that uses both local and global proxy service providers and 31% that make use of only global proxy services. On average, therefore, the international pension funds appear to use proxy services more often than their Dutch counterparts, while the Dutch pension funds make relatively less use of local proxy providers and relatively more use of only global providers. This seems to be in line with the more international investment focus of Dutch pension funds. The pattern differs notably for non-pension fund investors, but as the number of observations for these institutions is much smaller, these results should be interpreted with caution.

Table 8 also contains information about the corporate governance service providers that are used to supply the institutions with information and corporate governance reports on the companies in their portfolio. Similar to the use of proxy voting providers, about half of the Dutch pension funds use no corporate governance service provider (49%) at all, compared to 41% of international pension funds not using any of these services. And in line with the results on proxy voting above and the more international investment focus of Dutch pension funds, the international pension funds on average use exclusively local corporate governance service providers about twice as often as the Dutch pension funds (22% compared to 11% respectively). Again, the pattern differs notably

for non-pension fund investors, but as the number of observations for these institutions is much smaller, these results should be interpreted with caution.

There is an interesting relationship between these results, on the one hand, and the insights that resulted from the interviews, on the other. A large majority of (the Dutch) interviewees reported to use the services of ISS (Institutional Shareholder Services), a globally operating company that provides both corporate governance advice and proxy voting services. Within this group of informants, a concern was raised by a number of interviewees that ISS was nearing monopoly status ever since the ISS took over the Belgian, Dutch, and French corporate governance service units of Deminor in May 2005, which provided similar services. There was a widely shared expectation that the resulting market dominance will not have a positive influence on the quality of the services provided, and may also lead to a greater homogeneity of corporate governance reports to institutional investors, thereby increasingly losing country specific detail. Given that ISS is a global player it is not surprising that these concerns were raised by Dutch investors, as they have a more international investment focus and make less use of only local service providers, both in proxy voting services and obtaining corporate governance reports. Dutch investors thereby seem to have issued an “early warning signal” in regard to developments on the global market for shareholder services.

The dominant position of ISS is also significant for another reason. We conjectured earlier that shareholder activities of institutional investors may be motivated by symbolic rather than substantive reasons. That is, institutional investors may become active on their shareholdings not so much for what they expect to gain from it financially, but rather because they believe that such activities are symbolically appropriate, either in terms of a dominant cognitive logic that pervades the industry, or because of what they collectively believe institutional investors ought to be doing. It is well known from organizational research in other fields that intermediaries – such as management consultants and professional associations (e.g. Haunschild & Miner; 1997; Haveman, 1993) – often function as a mechanism through which organizations end up adopting highly isomorphic policies and organizational structures that hardly have any rational or functional justification (Geletkanycz & Hambrick, 1997; Lee & Pennings, 2002). The dominant position of ISS can be seen to raise the likelihood of institutional processes and their isomorphic effects, particularly since our interviewees have also aired their reservations in regard to what they perceive as overly uniform corporate governance reports they receive for different countries.

A third question on proxy voting addressed the issue of giving proxies to fellow shareholders. The results are presented in the bottom part of table 7. A very large majority of all pension funds do report not to give proxies to fellow shareholders, yet the number of Dutch pension funds that is inclined to give proxies to fellow shareholders is about twice as large as the number of international pension funds (16% and 8% respectively). The results for other institutional investors are remarkably different. While a large majority (71%) of the Dutch non-pension fund investors gives proxies to fellow shareholders, only a small minority (14%) of international non-pension fund investors seem to do so. On account of the low number observations in this category, however, the usual disclaimer applies to the interpretation of these results.,

#### **Target company selection motives**

An interesting question is the question which companies are targeted by institutional investors for shareholder activities. Table 9 identifies a number of different motives why portfolio companies are targeted for activism and also reports the aggregate answers given by the respondents. The latter were asked to indicate the degree to which they (dis)agree on a five point scale, ranging from strongly disagree on the one hand, to strongly agree, on the other. Within table 9, panel A summarizes the answers from the pension funds, panel B from the other institutional investors.

We include the scores of the different categories in this table because this is more informative than merely reporting the average and median scores. A first general observation based on the results presented in panel A of table 9 is that the answers seem to be concentrated in three (of five) categories. More specifically, the categories ‘disagree’

and ‘strongly agree’ are almost empty. Moreover, many respondents answered ‘neutral’ for a quite a number of questions, indicating that for many respondents the motives mentioned in these questions were neither here nor there in relation to their activities as shareholders. Keeping in mind the large percentages in the neutral categories, a number of observations are worth while reporting.

First, both Dutch and international pension funds indicate that that corporate governance issues constitute the most important reason for becoming active as shareholders, with this reason being more important for international pension funds (47% net agreement<sup>9</sup>) than for Dutch pension funds (25% net agreement). This coheres with the information conveyed to the researchers during the interviews with representatives from Dutch investors. Corporate governance issues are relatively easily observable, particularly since they are explicitly reported on by corporate governance service providers and also get attention in the media, thereby often gaining symbolic meaning with the public at large. Moreover, academic research on shareholder activism in the United States indicates that corporate governance reforms are typically the only tangible result from shareholder activism (Karpoff, 2001), which is presumably because corporate governance issues are relatively easily remediable (as compared to underperformance for example). Again, this finding signals that investor activism may be ceremonial rather than rational, as the rationality of shareholder activities has been challenged by the fact empirical research has found there to be no relation between shareholder activism induced corporate governance reforms, on the one hand, and firm value, on the other (see chapter 2).

Second, both Dutch (16 % net agreement) and international pension funds (16 % net agreement) report to become more active the larger their equity stake is in a company *relative to their own portfolio*. This is a remarkable result, as this reason should only be relevant for deciding which company *within* the portfolio should earn attention and could be subject to activism, but not for deciding to become active to begin with. On the other hand, the relative size of a company in the portfolio usually says something about the absolute size of the investment, and absolute size clearly is relevant in alleviating the transaction costs and collective action problems that burden shareholder activism.

What is remarkable, furthermore, is that for both Dutch and international pension funds, neither insider ownership of a target company, nor the possible business ties that investors themselves may have with target companies, and which may suppress their incentives for becoming active on that company on account of conflicts of interest, are believed to relevant motives for becoming active as shareholders. The latter is in line with expectations, as pension funds very often do not have business ties with portfolio companies.

The results of panel B show slightly different outcomes, with underperformance, the expectation of activism by other investors, and familiarity with the target company as additional motives for becoming active, and the degree of institutional ownership as (an additional) non-relevant reason. What goes against our expectations is the relatively large percentage of strong disagreement (67%) of Dutch non-pension fund investors with the motive signalling potential conflicts of interest (other business ties), but this result, as much as any other specific result in panel B of this table, may very well be the result of the low number of observations in this category of investors.

#### **Outsourcing asset management**

From the interviews we learned that quite a number of institutional investors outsource part or whole of their investments to other parties. These other parties are typically either highly specialized investors or institutions that invest in specific international markets such as the US or Japan. Outsourcing investments may clearly have

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<sup>9</sup> That is, the percentage of agreement (agree = strongly agree) – the percentage of disagreement (disagree = strongly disagree). The neutral score is not considered relevant.

Table 9 | Target company selection

	Dutch						International							
	average	median	strongly disagree	Disagree	neutral	agree	strongly agree	average	median	strongly disagree	disagree	neutral	agree	strongly agree
<b>Panel A: Pension fund</b>														
We tend to become more active...														
... with companies that are under-performing	2,9	3	25%	6%	34%	22%	13%	3,0	3	18%	5%	45%	20%	11%
... with companies with corporate governance issues	3,2	3	22%	0%	31%	28%	19%	3,6	4	14%	2%	20%	36%	27%
... when we hold a larger percentage of total outstanding voting shares of the target company	2,8	3	31%	0%	38%	22%	9%	2,9	3	16%	9%	50%	20%	5%
... when we know that other investors are also active in the target company	2,8	3	22%	3%	50%	19%	6%	2,8	3	20%	7%	44%	29%	0%
... when the level of insider ownership in the target company is higher	2,4	3	31%	3%	56%	9%	0%	2,7	3	16%	9%	64%	9%	2%
... when the level of institutional ownership in the target company is higher	2,5	3	25%	6%	63%	6%	0%	2,7	3	16%	7%	66%	11%	0%
... when our investment in the target company is large relative to our total investments	3,1	3	25%	0%	34%	25%	16%	3,0	3	13%	4%	49%	31%	2%
... on the shares of companies we know well	2,8	3	22%	0%	56%	22%	0%	2,8	3	18%	5%	59%	16%	2%
... on the shares of companies with whom we do not have close business ties	2,4	3	34%	3%	53%	9%	0%	2,4	3	32%	7%	57%	2%	2%
<b>Observations</b>	32							44						
<b>Panel B: Other institutional investors</b>														
We tend to become more active...														
... with companies that are under-performing	3,8	4	0%	0%	17%	83%	0%	3,0	3	0%	20%	60%	20%	0%
... with companies with corporate governance issues	4,2	4	0%	0%	17%	50%	33%	3,4	4	0%	20%	20%	60%	0%
... when we hold a larger percentage of total outstanding voting shares of the target company	4,3	5	0%	0%	33%	0%	67%	3,8	4	0%	17%	17%	33%	33%
... when we know that other investors are also active in the target company	3,3	3	0%	0%	67%	33%	0%	2,4	3	20%	20%	60%	0%	0%
... when the level of insider ownership in the target company is higher	2,3	2	0%	67%	33%	0%	0%	2,8	3	20%	0%	60%	20%	0%
... when the level of institutional ownership in the target company is higher	2,5	2,5	0%	50%	50%	0%	0%	3,0	3	0%	20%	60%	20%	0%
... when our investment in the target company is large relative to our total investments	4,0	4	0%	0%	33%	33%	33%	3,8	4	0%	17%	17%	33%	33%
... on the shares of companies we know well	3,8	4	0%	17%	0%	67%	17%	3,2	3	0%	17%	67%	0%	17%
... on the shares of companies with whom we do not have close business ties	1,7	1	67%	0%	33%	0%	0%	2,4	3	20%	20%	60%	0%	0%
<b>Observations</b>	6							5						

consequences for engaging in shareholder activities on account of the loss of control over the investment portfolio. Table 10 provides information on investment outsourcing by the institutional investors in our sample. What is immediately evident from this table is that a large majority of the pension funds outsource asset management to an external party (74% of the Dutch pension funds outsource a part or all their domestic investments and 78% outsource part or all of their foreign investments), and that outsourcing is typically an all or nothing policy as is evident from the across the board median 100 % answer to the question what fraction of investments is outsourced to an other party. The table also provides information on non-pension fund investors, but due to the limited number of observations, these figures are hardly informative.

**Table 10** | *Outsourcing asset management*

	Pension funds		Other	
	Domestic	Foreign	Domestic	Foreign
<b>Equity investment managed by external party</b>				
Yes	74%	78%	29%	50%
No	26%	22%	71%	50%
Observations	96	92	7	6
Average percentage	75%	82%	100%	100%
Median percentage	100%	100%	100%	100%
<b>Observations</b>	68	65	2	2

Because outsourcing asset management affects the possibility of being active on investments, we have also confronted respondents with a number of statements regarding six aspects of outsourcing asset management that are relevant from the perspective of shareholder activities. These statements, together with the responses given, are specified in table 11. Again, we provide both averages and percentages on each score, but this time only for the pension funds as the number of observations for non-pension fund investors is too low.

A number of observations can be made from table 11. First, there seem to be hardly any differences between Dutch and international pension funds, with both kinds of funds roughly displaying a similar pattern of activities. Second, only about a third of all pension funds indicates that they vote on securities whose management they outsource (sum of categories 'agree' and 'strongly agree'), while at the same time more than 50% of the pension funds do not vote at all on securities they outsource (sum of categories 'disagree' and 'strongly disagree'). A roughly similar result, third, applies to voting instructions given to an external party: about 25%-30% of the pension funds gives voting instructions, while more than 50% does not. Fourth, about 60% of the pension funds (70% for international pension funds) requires external parties to provide them with voting summary information, while roughly 30% does not seem to be interested in this information. Pension funds also seem to be interested in reports about shareholder activities other than voting undertaken by external parties (34% and 48% for Dutch and international funds respectively). Note that average scores on receiving some feedback on shareholder activities by the external parties are the highest of all activities that pension funds undertake, which signals a rather passive stance of institutional investors regarding the asset management they outsource. This is a telling result given that a large majority of pension funds outsource the management of a large majority of their assets. Due to the low number of observations, we cannot draw any sound conclusions from the information on other institutional investors. An addition word of caution is that the question concerning specific instructions may have been interpreted by the respondents in two ways; as providing the general voting policy as a guideline or as specific voting requirements.

#### **Frequency and importance of shareholder activities**

As explained above, an important part of our survey involved questions that intended to measure the frequency with which investors have undertaken different kinds of activities on their portfolio companies over the last year.

Table 11 | *Voting and outsourcing*

	<i>average</i>	<i>median</i>	<i>disagree strongly</i>	<i>disagree</i>	<i>neutral</i>	<i>agree</i>	<i>agree strongly</i>
<b>Panel A: Pension funds Dutch</b>							
We vote on the securities whose management we outsource to an external party	2,5	1	55%	2%	9%	8%	26%
We give specific voting instructions to the (or some other) external party	2,5	2	46%	9%	15%	9%	20%
We request the (or some other) external party to provide us with voting summary reports related to these securities	3,4	4	29%	2%	14%	14%	42%
We are interested in shareholder activities (other than voting) related to these securities	2,9	3	25%	8%	34%	20%	14%
We give specific instructions to the (or some other) external party regarding shareholder activities (other than voting)	2,2	2	45%	11%	28%	14%	3%
We request the (or some other) external party to provide us with reports about the shareholder activities (other than voting) they undertake	2,8	3	31%	14%	22%	15%	18%
<b>Panel B: Pension funds International</b>							
We vote on the securities whose management we outsource to an external party	2,2	1	58%	4%	9%	15%	13%
We give specific voting instructions to the (or some other) external party	2,2	1	52%	9%	13%	13%	12%
We request the (or some other) external party to provide us with voting summary reports related to these securities	3,4	4	26%	1%	12%	24%	37%
We are interested in shareholder activities (other than voting) related to these securities	2,9	3	26%	9%	27%	27%	11%
We give specific instructions to the (or some other) external party regarding shareholder activities (other than voting)	2,1	2	48%	10%	24%	15%	3%
We request the (or some other) external party to provide us with reports about the shareholder activities (other than voting) they undertake	2,8	3	34%	13%	15%	21%	18%

The activities listed in table 12 range from passive (e.g. information gathering) to active (e.g. submitting proposals to shareholder meetings), on the one hand, and from public (e.g. making public communications) to private (e.g. engaging in private negotiations with management), on the other. Respondents were asked to rate the frequencies with which they undertook these different kinds of activities on a scale that ranges from 1 (“never”) to 5 (“almost always”). In addition, we have also asked investors to indicate the (perceived) importance they attach to these different kinds of shareholder activities on a scale that ranges from 1 (“not important”) to 5 (“very important”). It is crucial to remember that we asked respondents to rate these variables separately for their domestic investments and their investments abroad (i.e. the country in which they hold the largest foreign investments). This separate measurement was the result from insights obtained through the interviews, where many interviewees indicated that they had different activity regimes in place for domestic and foreign investments. Table 12 lists the mean and median results for different kinds of shareholder activities.

Panel A describes the activities of pension funds in the past year and the subjective importance these activities are perceived to have. It is perhaps most informative to start with three observations that apply across the board. This is, first, that pension funds are generally more active on domestic investments than they are on international investments. As explained above, this finding was expected from the interviews and it also seems to make common sense. Domestic activism is both more convenient – given the home investment bias – and cheaper, particularly for activities for which the cost increases with distance, such as attending shareholder meetings. Second, pension funds generally find shareholder activities more important than can be inferred from the frequencies with which they undertake these activities. Although this observation should be interpreted with care (because it is difficult to compare quantities representing very different questions) it also indicates an insight that

Table 12 | Frequency and importance of shareholder activities

	Dutch						International									
	Domestic			Foreign			Domestic			Foreign						
	Frequency average median	Importance average median														
<b>Panel A: Pension Funds</b>																
a	2,3	1	3,1	3	2,0	1	3,4	3	3,3	3	3,6	4	3,0	3	3,3	3
b	2,2	2	3,1	3	1,4	1	2,9	3	2,0	2	2,5	2,5	1,6	1	2,4	2,5
c	2,2	2	3,2	3	1,5	1	2,9	3	1,6	1	2,4	3	1,3	1	2,3	2,5
d	2,8	3	3,5	3	2,1	1	3,4	3	3,4	4	3,8	4,5	3,1	3	3,5	4
e	1,5	1	3,1	3	1,4	1	3,2	3	1,8	1,5	2,7	3	1,4	1	2,4	2
f	2,0	2	3,3	3	1,8	1	3,2	3	2,4	2	3,2	3	2,2	2	3,1	3
g	2,1	2	3,2	3	1,6	1	3,1	3	2,2	2	2,8	3	2,1	1,5	2,8	3
h	1,6	1	2,7	3	1,5	1	2,9	3	1,8	1	2,5	3	1,6	1	2,3	2,5
i	2,5	3	3,5	4	1,8	1	3,1	3	2,4	2	3,0	3	2,3	2	3,0	3
j	2,3	2	3,5	3	1,7	1	3,1	3	2,3	2	2,8	3	2,1	1,5	2,6	3
k	1,7	1	3,1	3	1,4	1	3,0	3	1,9	2	2,7	3	1,6	1	2,6	3
l	1,6	1	2,7	3	1,4	1	2,7	3	1,8	1	2,5	3	1,6	1	2,4	2,5
m	1,2	1	2,8	3	1,3	1	3,1	3	1,3	1	2,4	2	1,3	1	2,3	1,5
Observations	17		15		16		14		24		21-22		18-19		16-17	
<b>Panel B: Other Investors</b>																
a	4,4	5	4,8	5	2,0	2	4,0	4	2,7	2,5	3,2	3	3,3	3	3,7	3
b	3,4	3	4,2	4	1,5	1,5	4,0	4	2,5	2,5	3,0	3	3,3	3	3,7	3
c	3,6	4	4,2	4	1,5	1,5	4,0	4	1,8	1,5	1,8	1,5	2,0	2	1,5	1,5
d	3,0	2	3,8	4	3,0	3	4,0	4	3,3	3	3,4	3	4,3	5	4,3	5
e	2,2	3	3,2	3	1,0	1	3,0	3	1,5	1	2,0	2	1,7	1	2,0	2
f	2,8	3	3,6	4	2,5	2,5	3,5	3,5	1,5	1	2,3	2	2,0	2	2,5	2,5
g	3,0	3	3,6	4	2,0	2	4,0	4	2,0	2	2,8	4	2,3	3	2,5	2,5
h	1,6	1	2,6	3	2,0	2	3,5	3,5	1,8	1,5	2,0	2	2,3	2	2,0	2
i	2,8	3	3,6	4	2,0	2	4,0	4	2,8	3	3,0	3	3,0	3	3,0	3
j	3,0	3	3,8	4	1,5	1,5	4,0	4	1,8	1,5	2,3	2	2,3	2	2,0	2
k	1,8	2	3,4	3	2,0	2	4,0	4	1,8	1,5	2,0	2	2,0	2	2,0	2
l	1,4	1	2,2	2	1,5	1,5	2,5	2,5	1,2	1	2,0	2	1,0	1	2,0	2
m	1,2	1	3,2	3	1,0	1	3,0	3	1,3	1	2,0	2	1,7	1	2,0	2
Observations	5		5		2		2		6		4-5		3		2-3	

seems to apply to shareholder activities in general. This is that their availability – i.e. the possibility of undertaking them – is typically found to be more important than their actual occurrence. This is particularly true for activities that seem to be low base rate phenomena to begin with, such as calling an extra ordinary shareholder meeting. The findings here therefore confirm that one should be very careful to infer from a low degree of shareholder activities that these activities therefore do not matter much, as they, like a bill of rights or a constitution, matter most under relatively rare conditions.

Third, except for asking questions at shareholder meetings and having private communications with representatives of portfolio companies, international pension funds seem to be more active than Dutch pension funds, both on their domestic and their foreign investments.

When we focus on the Dutch pension funds only, we can see that the activities “(proxy) voting at shareholder meetings” and engaging in private communications with representatives of portfolio companies are relatively the most frequently occurring activities, while they are also found to be the most important, together with “engaging in private coordination with other shareholders”, “asking questions at general meetings” and “voting against management proposals”. The latter seem to be a logical next step to the former, which apparently materializes only under certain conditions. Additionally, “in-house information gathering” is found to be relatively more important for foreign investments of Dutch pension funds, which again makes common sense given that these activities can be undertaken from the home country.

If we subsequently focus on international pension funds, we can observe a roughly similar pattern, but with a few exceptions. As already explained above, the international pension funds seem to be more active than the Dutch pension funds. The categories “in-house information gathering” and “proxy voting” stand out in particular. Another interesting finding is that international pension funds seem to engage more in public coordination with other shareholders, as opposed to the Dutch pension funds who seem to engage more in private coordination. International pension funds also value the importance of some particular shareholder activities somewhat differently as compared with their Dutch counterparts, with a relatively stronger emphasis on “in-house information gathering” and proxy voting”. Reversely, Dutch pension funds seem to prefer private communications and coordination more than international pension funds. Finally, international pension funds perceive the importance of shareholder activities on international investments to be lower compared to their domestic investment, which is consistent with how they act.

The low number of observations for non-pension fund investors makes it difficult to tell whether non-pension fund investors significantly diverge from the pattern described above.

#### 4.4

#### Motives for becoming active

We also asked respondents about the motives why they become active on their portfolio holdings. Within the many different motives listed in the survey, we distinguish roughly three different kinds of motives: rational motives, cognitive institutional motives and normative institutional motives.

Rational motives are motives that can be seen as rational from a cost-benefit consequentialist perspective. Although these motives are very similar to the common or garden economic motives that are typically given in defense of shareholder activities, we have emphasized rational procedures and evaluation of shareholder activities in our survey, precisely because both conventional wisdom and empirical research on shareholder activism has questioned whether shareholder activities make economic sense as a matter of fact. Thus only if investors rationally evaluate and decide whether or not to engage in shareholder activities, will they score high on the items that intend to capture these motives.

Cognitive institutional motives, in contrast, are motives that derive from the dominant logic that presently guides our collective understanding of corporate governance in general, and shareholder activism in particular. This logic

consists of cognitive frames of mind that capture how things are *perceived* to be and work, rather than how things really are or work as a matter of fact. Shareholder activism, for example, is generally believed to have a beneficial contribution to corporate financial performance, while virtually all existing empirical research contradicts that assumption. Hence although the economic agency theory logic that presently guides our understanding of corporate governance is often perceived as rational, it may not be rational as a matter of fact on account of the lacking empirical support for the assumption that shareholder activism matters to performance.

Normative institutional motives for shareholder activism, finally, are the motives that derive from what is generally believed to be appropriate to do. In this view, institutional shareholder activism is believed to result from a fiduciary obligation of asset managers to the shareholders or beneficiaries of the institutions they represent, regardless of whether investor activism is beneficial for shareholders or beneficiaries as a matter of fact. Being active is what one is supposed to do as an asset manager in a similar way that a doctor is expected to cure patients, even if effective treatment options are lacking as a matter of fact. Treating patients is simply what doctors do, and is also what is normatively expected from doctors. In a similar vein, society seems to perceive institutional shareholder activities as something that is morally required.

Table 13 lists the different motives for being active and presents the results. Similar to how we presented frequency and importance of shareholder activities, we distinguish between the domestic and (largest) foreign investment country in order to analyse any potential differences in policies and opinions.

If we discard non-pension fund investors on account of the low number of observations in this category we can begin with making a number of general observations. This is, first, that most motives mentioned in the table seem to play some role in decisions to become active. Second, international pension funds generally seem to score lower on most motives. We have no explanation for this. Third, there seem to be two motives that are relatively low across the board. These are the motives that intend to capture rational decision making by spending significant resources on measuring (i) the costs and (ii) benefits of shareholder activities. This finding is consistent with the results from the interviews. During the interviews with Dutch investors no informant said to diligently monitor the costs and benefits of their institution's shareholder activities. This speaks against a rational assessment of shareholder activities by investors, even if we discount for the many difficulties of measuring possible benefits that were mentioned during the interviews. This is because monitoring expenses of shareholder activities is relatively easy, while the average score on that item is about equally low.

If we look at Dutch pension funds only, the five most important reasons (average >3,4) are:

1. We know that activism has a positive relationship with total shareholder returns (b).
2. The activities of other institutional investors influence our activities as shareholder (c)
3. We assume, but have no proof, that activism has a positive relationship with total shareholder returns (i).
4. The general view that corporate governance matters influences our shareholder activities (n).
5. Professional networks inspire us to be more active (q).

It is interesting to note that of these motives, four relate to (cognitive) institutional factors, whereas only one can be qualified as rational (b). Hence Dutch pension funds seem predominantly driven by institutional rather than rational motivations.

The international pension funds show somewhat different results, as their motivations for becoming active are rather different than the motivations that drive Dutch pension funds. The five most important reasons (average >3,4) are:

1. Our decisions to be active are based on a thorough cost-benefit analysis (a).
2. We know that activism has a positive relationship with total shareholder returns (b).
3. We feel that our primary beneficiaries want us to be active (d).

Table 13 | Motives for shareholder activities

Motivations	Pension funds												Other					
	Dutch				International				Dutch				International					
	Domestic		Foreign		Domestic		Foreign		Domestic		Foreign		Domestic		Foreign			
average	median	average	median	average	median	average	median	average	median	average	median	average	median	average	median			
a Our decisions to be active are based on a thorough cost-benefit analysis	2,9	3	2,8	3	3,2	3	3,0	3	3,2	4	3,5	3,5	3	3,0	3			
b We know that activism has a positive relationship with total shareholder returns	3,8	4	3,3	3	3,4	4	3,3	3	3,6	4	3,5	3,5	3,2	3,5	4			
c The activities of other institutional investors influence our activities as shareholder	3,4	3	3,6	3,5	2,9	3	2,9	3	3,2	3	3,5	3,5	3,0	3	3,0			
d We feel that our primary beneficiaries want us to be active	3,1	3	3,0	3	3,2	4	3,2	3	3,0	3	3,5	3,5	3,3	3,5	4			
e We monitor the results of our activism closely after the fact	3,1	3	2,8	3	3,3	3	3,3	3	2,8	3	3,5	3,5	3,0	3	3,0			
f State-led commissions or societal associations prompt us to be active	3,1	3	3,1	3	2,4	3	2,4	3	2,4	2	3,0	3	2,5	3	2,3			
g We are active only when the chances of reaching our objectives are high	2,8	3	2,9	3	2,5	3	2,6	3	2,6	3	3,0	3	2,8	2,5	2,7			
h Activism is our insurance against uncertainty	2,6	3	2,8	3	2,5	3	2,6	3	2,0	2	3,0	3	3,0	3	3,0			
i We assume, but have no proof, that activism has a positive relationship with total shareholder returns	3,8	4	3,3	3	2,7	3	2,8	3	3,2	4	3,5	3,5	3,2	3	3,3			
j We feel pressures from our stakeholders to be active	2,9	3	2,8	3	2,4	2	2,7	3	3,0	3	3,5	3,5	2,3	2,5	2,7			
k We invest significant resources in measuring the costs of shareholder activism	2,3	2	2,6	3	2,1	2	2,2	2	2,0	2	2,5	2,5	1,8	1	2,0			
l We invest significant resources in measuring the benefits of shareholder activism	2,2	2	2,6	3	2,2	2	2,2	2	1,6	2	2,5	2,5	1,8	1	2,3			
m We feel it is our obligation to the society to be active	3,3	3	3,3	3	3,0	3	2,5	2,5	3,6	4	3,5	3,5	3,0	3	3,0			
n The general view that corporate governance matters influences our shareholder activities	3,8	3,5	3,5	3	3,1	3	3,1	3,5	3,6	4	3,5	3,5	3,0	3	2,3			
o We gather information on several strategies, including “voting with our feet”, before we decide to be active	3,0	3	2,9	3	2,9	3	2,7	3	3,8	4	3,5	3,5	3,0	3	3,0			
p We actively seek feedback on the success of our interventions	2,8	3	2,7	3	2,9	3	2,8	3	2,6	3	3,0	3	3,0	3	3,0			
q Professional networks inspire us to be more active	3,4	4	3,4	4	2,8	3	2,6	3	3,6	4	3,5	3,5	3,2	3,5	2,7			
r We follow the activism policy of other large, visible investors	3,3	3	3,2	3	2,5	3	2,4	3	3,8	4	3,5	3,5	2,3	3	2,3			
Observations	16		16		23		18		5		2		6		3			

4. We monitor the results of our activism closely after the fact (e).
5. The general view that corporate governance matters influences our shareholder activities (n).

In contrast with the Dutch pension funds, international pensions funds appear to be more motivated by rational factors, as three out of the five highest scoring factors can be classified as such (a, b, e), while only two high scoring motives intend to capture institutional motivations. Furthermore, one of these motivations is of a normative institutional nature (d) and one is of a cognitive institutional nature (n).

Although these broad comparisons of motivations between different investors are indeed informative, the next section will investigate in more detail how different motivations contribute to the reported frequencies of different kinds of shareholder activities through a regression analysis. This analysis will simultaneously attempt to establish the effect of other factors discussed in this section on the reported frequencies of different kinds of shareholder activities. For now, it is important to note that the respondents explicitly confirm that they are driven by both rational and institutional motivations, and that this is particularly true for Dutch investors. This indicates once more that there is a 'ceremonial' dimension to shareholder activities of institutional investors.

#### Factors that influence shareholder activities of Dutch institutions

In addition to the previous paragraph where we investigated different kinds of motivations for being active, we asked only Dutch institutional investors (pension funds and other institutional investors) about specific factors that influence their (proxy) voting behaviour. Again, we make a distinction between domestic and foreign market. Table 14 presents the results. Given the low number of observations for non-pension fund investors, we can again only draw conclusions based on the answers provided by pension funds.

**Table 14** | *Statements on (proxy) voting by Dutch institutions*

Factors that influence activities	Pension funds				Other			
	Domestic		Foreign		Domestic		Foreign	
	average	median	average	median	average	median	average	median
a There are legal requirements to vote on the shares in our portfolio	3,3	3	3,4	3,5	2,8	3	3,5	3,5
b There are legal requirements to display other forms of activism besides voting	3,0	3	3,3	3,5	2	2	2,0	2
c There are proxy voting regulations which enable investors to vote by proxy	3,4	3	3,4	3	3,4	4	2,5	2,5
d There are legal regulations that discourage private communication between institutional investors and portfolio companies	3,6	3	3,6	3,5	4	4	3,5	3,5
e There are legal regulations that discourage private communications among institutional investors	2,7	3	3,1	3	3,6	4	3,5	3,5
f There are share blocking regulations that require shareholders to deposit their shares before the date of the meeting	3,1	3	3,1	3	3,4	3	4,0	4
g We receive enough information from the portfolio companies to formulate our voting decision	3,0	3	3,1	3	3	3	2,5	2,5
h We receive timely information from the portfolio companies to formulate our voting decision	3,2	3	2,8	3	2,4	2	2,0	2
i The information we receive from our proxy voting provider to formulate our voting decision is always very accurate	2,9	3	3,0	3	3	3	2,5	2,5
j The information we receive from our proxy voting provider to formulate our voting decision is always timely	2,9	3	2,8	3	2,8	3	2,0	2
k We always request vote summary reports from our proxy voting provider	3,2	3	2,9	3	3,2	3	3,5	3,5
l We always receive vote summary reports from our proxy voting provider	3,1	3	2,9	3	2,8	3	2,0	2
m We receive guidelines to governance from the final beneficiaries of our investments	2,7	3	2,7	3	3	3	2,5	2,5
<b>Observations</b>	15-17		15-16		5		2	

Three factors that are reported to influence shareholder activities most are (in decreasing order of strength): (i) legal regulations that discourage private communication between institutional investors and portfolio companies (3,6), (ii) legal requirements to vote on shares in the portfolio (average 3,3), and (iii) proxy voting regulations that

enable investors to vote by proxy (3,4). The results for the investments in the largest foreign country are roughly similar; with the exception that the factor: “legal requirements to display other forms of activism besides voting” is additionally believed to be of influence.

These findings can be interpreted with the aid of insights that derive from the interviews. First, the legal requirements that discourage private communication between institutional investors and portfolio companies result from insider trading laws. These laws are said to create uncertainty with respect to the question what kind of private engagement with management of portfolio companies are allowed for investors, both in the Netherlands and in foreign jurisdictions. The United States fiduciary duties (under ERISA) to be active on shareholdings (including proxy voting) were also mentioned as relevant, while proxy voting regulations were often seen as frustrating the voting process on account of blockages on trading the shares one intends to vote on, and the high transaction costs of cross border voting. Some informants even said that trade blockages were the single most important barrier to voting on all of the shares held of a particular company.

### **Antecedents of investor activism**

In the previous analyses we merely tabulated the relative frequencies and importance of activities employed by investors on a 1-5 scale, using a cross tables to analyze differences between Dutch and international pension funds, on the one hand, and Dutch and international non-pension funds investors, on the other. Many factors potentially explain these activities, including: (1) the country of origin of the investor, (2) the size and composition of the portfolio, (3) whether or not asset management has been outsourced and (4) different kinds of motivation that drive investors to become active on shareholdings in their investment portfolios. In this section we perform an analysis in which we will attempt to explain the variation in shareholder activities from a number of factors, some of which we have explored above. The analysis we perform involves a multi-variate regression analysis with the frequency of shareholder activities as explanandum (or dependent variable), on the one hand, and investor and investment characteristics as explains (or independent variables), on the other.

In our survey we have asked the respondents to answer a number of questions on their shareholder activities regarding (i) investments in their home country and (ii) investments in the largest other country. For each respondent with a fully completed questionnaire we therefore have two observations of the frequency with which shareholder activities take place, that is, those pertaining to home and those pertaining to foreign investments. The variables to be explained and the variables that are doing the explanatory work were all measured in our survey and are detailed below.

Variables to be explained:

- FREQUENCY: average score on the 13 questions measuring the frequency with which different kinds of shareholder activities take place.
- FREQUENCY-MEETING: average score on the questions that intend to measure the frequency with which the more passive activities regarding general shareholder meetings take place (table 13: a, b, c, and d).
- FREQUENCY-ACTIVE MEETING: average score on the questions that intend to measure the frequency with which the more active shareholder activities regarding general meetings take place (table 13: e, f, and m)
- FREQUENCY-PUBLIC: average score on the questions that intend to measure the frequency with which public coordination and communication by shareholders takes place (table 13: g and h)
- FREQUENCY-PRIVATE: average score on the questions that intend to measure the frequency with which private coordination and communication between shareholders or target company management take place (table 13: i, j, k, and l).

Explanatory variables:

- NL, UK, US, and CA: are dummy variables with value of one in case home country is, respectively, The Netherlands (43,5% of the sample), United Kingdom (14,1%), United States (13,0%), or Canada 11,9%), and zero

otherwise. The data also contains observations from Italy (5.4%), Norway (7.6%) and Germany (1.1%); these country effects are incorporated in the intercept of our regression model, however.

- Home: is dummy variable with value of one if frequency is measured in the institution's home country investments, and zero if otherwise. In total 56,4% of the observations concern home country investments.
- F\_UK, F\_US: dummy variables with value of one in case largest foreign country is the UK (13,0%) or US (38,0%), respectively.
- PUPF, PRPF: dummy variables for institutions labeled as public pension fund (PUPF, 41,3%) or private or company pension fund (PRPF, also 41,3%) respectively. The other groups are banks (4,3%), insurers (5,4%) and mutual funds (7,6%); these categories end up in the intercept.
- GUARANT: dummy variable for pension funds with guaranteed payouts to beneficiaries. 72,8% of the sample is in this category.
- SIZE: the funds' total investments in all assets in millions of Euros. The variable is included in the regression using a logarithmic rescaling, because the marginal effects of size are expected to be decreasing. The median size is 5.046 million Euros.
- EQ\_PART: the ratio of the equity investments in the home and largest foreign country and total equity investments. Average is 0,309 (median is 0,214), which implies that the investors have relatively large parts of their equity investments in their home country and the largest foreign country. This variable is available for 73 (of the 92) observations.
- MOTIVE-RATIONAL: average score on the questions that intend to measure *rational* motives for shareholder activism (table 14: a, b, e, g, k, l, o, p). These are motives that can be seen as rational from an economic consequentialist perspective.
- MOTIVE-INSTITUTIONAL C: average score on the questions that intend to measure *cognitive institutional* motives for shareholder activism (table 14: c, h, i, n, q, r). These are motives that derive from a dominant logic that guides our understanding of corporate governance and shareholder activism. It consists of frames of how things are perceived to be and work rather than how things really are or work as a matter of fact. Shareholder activism, for example, is generally believed to have a beneficial contribution to corporate financial performance, while virtually all existing empirical research rejects that assumption.
- MOTIVE-INSTITUTIONAL N: average score on the questions that intend to measure normative institutional motives for shareholder activism (table 14: d, f, j, m, q). These are the motives that derive from what is generally believed one ought to do. In this particular case institutional shareholder activism is generally believed to result from a fiduciary obligation of asset managers to the shareholders or beneficiaries of the institutions they represent, regardless of whether investor activism is beneficial for shareholders or beneficiaries as a matter of fact.

The regression results presented below are based on Ordinary Least Squares regressions, applying mean imputation for missing values in the survey responses to the questions of activities and motivations. The regressions are based on 92 observations, unless EQ\_PART is included, in which case the number of observations is 73. The results of the regressions tests are summarized in the table 15 below, which contains the signs of the coefficients and significance levels.

Table 15 contains a set of regressions explaining the frequency of shareholder activities. The country dummies show that the UK has a positive effect in five regression models, while Canada has a positive effects in three models specified. Although the results are not conclusive, these finding indicate that UK and Canadian investors are relatively more active than investors from other countries.

The home country dummy is always significant, which is therefore a very strong result. Investors can be said to be generally more active in their home countries than in the foreign countries in which they invest. The coefficient of around 0,30 indicates that investors are a factor 0,30 more active on the 1 to 5 scale. The foreign country dummies for the UK and US are insignificant.

**Table 15** | Regression analysis of frequency of activities

	Frequency							
Intercept	1,71***	1,94***	1,44***	0,83**	-0,40	-0,40	-0,09	-0,60
NL	0,11	0,23	0,44	0,61**	0,30	-0,11	0,01	0,08
UK	0,65**	0,83**	0,70*	0,93***	0,57**	0,40	0,36	0,42
US	-0,21	-0,18	0,14	-0,03	-0,18	-0,21	-0,29	-0,23
CA	0,52	0,61	0,77**	0,97***	0,60**	0,21	0,37	0,40
HOME	0,34*	0,61*	0,41**	0,32**	0,33**	0,28**	0,30**	0,31**
F_UK	-0,17	-0,23	-0,41	-0,34				
F_US	-0,14	-0,06	0,03	-0,23				
PUPF		-0,20	0,73**	0,38	0,23	0,25	0,22	0,20
PRPF		-0,57**	0,31	0,26	0,12	0,31	0,21	0,18
GUARANT			-1,25***	-0,77***	-0,54***	-0,62***	-0,47**	-0,51**
LOG(SIZE)			0,05	0,11***	0,10***	0,09***	0,09***	0,10***
EQ_PART			0,16					
MOTIVE – RATIONAL					0,49***			0,13***
MOTIVE- INSTITUTIONAL C						0,11***		0,19
MOTIVE INSTITUTIONAL N							0,10***	0,16

\* indicates significance at the 10% level, \*\* at 5% level and \*\*\* at 1% level.

The variables for public and private pension funds are both significant only in one regression model. This indicates that the type of institution does not have an important impact on institutional investor activity. The dummy for guaranteed payouts is always significantly negative. This, again, is a strong result that implies that funds with obligations that derive from defined benefit pension plans are less active than funds with defined contribution plans. This goes against our expectations formulated in chapter 2. Apparently, guaranteed payouts stimulate asset managers to be less rather than more active on their investments. The size of the institution is always significantly positive, with only one exception. Clearly, larger funds are more active. The variable for the relative amount of equity is insignificant.

The three types of motives – rational, cognitive institutional and normative institutional – are strongly correlated. Therefore we first include each type separately. These regression models show that the motives are always positively related to activity. More interesting is that the rational motives exhibit the largest coefficient. In the final regression we include all three motives. Where these motives compete as explaining variables, the rational motives turn out to remain the only significant determinant.

In table 16 we conduct a separate analysis for four different types of activities that institutions engage in and relate these to the determinants of shareholder activities analyzed before.

Again, the country effects are relatively stable over the four categories of activities, although not significant in all cases. The home country dummy is significant for meeting activity and for private communication and coordination. This result is both interesting and unsurprising. It is unsurprising because it seems only common sense that investors tend to attend more meetings and approach more firms in private engagement in their home country than in foreign countries in which they hold investments, even if only on account of convenience and cost considerations. It is interesting because it allows us to unpack the home country finding in terms of convenience and cost considerations, as this effect is only significant where these considerations play a large role. Seen in this way, the home country effect need not signal irrational or irresponsible investor behavior, as it at the very least seems consistent with what a cost-benefit analysis would dictate. It is also largely consistent with what was said in the interviews, where many informants indicated that proxy voting is the most important shareholder activity for foreign investments, while private engagement and attending shareholder meetings are the preferred activities

of Dutch investor representatives. The effect of public and private pension funds is only significant in private communication. The results for guaranteed payouts and size are consistent over activity types.

**Table 16** | *Regression analysis of frequency of activities*

	Frequency			
	Meeting	Active Meeting	Public	Private
Intercept	1,23**	0,98***	0,50	0,69
NL	0,29	0,37*	0,47	0,70**
UK	0,69*	0,78***	0,92**	1,09***
US	-0,42	-0,06	-0,10	0,30
CA	0,71*	0,78***	0,59	0,95***
HOME	0,50**	0,16	0,24	0,30*
PUPF	0,02	0,44	0,35	0,85***
PRPF	-0,09	0,32	0,04	0,64***
GUARANT	-0,62***	-0,64***	-0,49	-1,21***
LOG(SIZE)	0,13***	0,05*	0,13***	0,09**

\* indicates significance at the 10% level, \*\* at 5% level and \*\*\* at 1% level.

## 5 | SUMMARY AND CONCLUSIONS

This study focused on the shareholder activities of institutional investors. It covered three main areas: (1) a concise review of relevant theory and existing empirical research, (2) a discussion of legal issues that arise when investors intend to become active on their shareholdings in the Netherlands, and (3) an empirical analysis based on both interviews with key representatives of Dutch institutional investors and a survey sent to institutional investors in 8 different countries. We briefly rehearse our main findings and also suggest some issues that require further attention, either from researchers or from practitioners in the field.

### Theory and research on shareholder activities

We have argued that shareholder activism is conceptually best understood as a means of corporate governance in the pursuit of shareholder wealth maximization. This perspective has led us to define shareholder activism in contradistinction to alternative instruments of corporate governance, on the one hand, and ordinary portfolio management, on the other, as all actions, other than seizing control or selling shares, that shareholders undertake within a *given* shareholder relationship with a portfolio company in order to influence either the governance, management or performance of that company. This definition has a relatively broad extension and includes both private and public actions, as well as both passive and more active shareholder activities. We also use this relatively broad definition in the measures of shareholder activity we employ in our empirical research.

From the literature, we found that the utility of shareholder activism as an instrument of corporate governance is largely conditioned by the factors that burden shareholder activities. These factors affect the transaction costs and collective action problems that burden shareholder activities, and are generally taken to include: (1) the degree to which shareholdings are dispersed, (2) informational and legal barriers that stand in the way of exercising shareholder voice, (3) and the level of inside ownership in the target firm. Inversely, factors that facilitate shareholder activism are taken to include: (1) ownership concentration and (2) the degree of institutional ownership on the one hand, and (3) the absolute size of the equity holding in the target firm, on the other. Because the factors that burden shareholder activities are abundantly present, some authors have claimed that shareholder activism makes little sense, except under very specific conditions. And because these conditions are found to be relatively rare, shareholder activism, in this view, is seen as an *ultimum remedium* that should be put to use only after a thorough cost-benefit analysis has been made. Ultimately, however, it is the availability of the option of shareholder voice, rather than its actual exercise, that matters most.

The bulk of empirical research on shareholder activism has focused on the relation between activism and performance and is mostly about shareholder activism in the United States. The results are mixed: some studies find positive effects of shareholder activism on targeted firms, while others conclude that shareholder activism has a negligible impact on target firm performance (measured as market value or some measure of accounting profit). These conflicting findings are largely attributable to the different methodologies and measures used. If we account for these differences, shareholder activism can be seen to affect management or governance changes in target firms, but ultimately not firm value. One explanation for this is that shareholder activism is often focused on corporate governance objectives that have not been found to matter to firm value. Another is that different kinds of shareholder activities have been found to have differential effects on firm value, with private engagements seemingly faring better in this respect than public activities. These findings indicate a need for more fine-grained empirical research on the activism-firm value relationship.

In spite of being inconclusive on the instrumental rationality of shareholder activism, previous empirical research has highlighted some other interesting findings. This is, first, that the firms targeted for activism are: (1) relatively

large, (2) have relatively poor performance and (3) a relatively high institutional ownership, while (4) simultaneously displaying relatively low degree of insider ownership. Although not much research has been done on the reasons why institutional investors become active on their shareholdings, some predictions have been formulated. Investors are hypothesized to be more active when: they (1) are pension funds, (2) the more they have obligations deriving from defined benefit pension funds, (3) are larger as measured by the size of their portfolio, (4) the longer their investment horizon is, and (5) the larger the fraction of the investment portfolio that is passively managed. In addition, (6) legal restraints are conjectured to have a negative effect on activism while (7) the effect of the degree to which asset management is outsourced can apparently go both ways.

We have argued, however, that research and theory building that is not directly related to shareholder activism may also shed interesting light on the factors that drive institutional investor activism. More specifically, research on economic organization in general indicates that organizational forms and policies are often not rationally adopted on account of their functionality, but are rather symbolically adopted in order to secure legitimacy from the organizational environment. These so-called 'institutional' explanations of organizational structures and policies have already been found to be empirically very powerful in corporate governance research in general. This has drawn our attention to the ceremonial dimension of shareholder activism. It should be clear, however, that a symbolic interpretation of shareholder activism defies the instrumentally rational understanding that currently dominates the field.

#### **Legal issues regarding shareholder activities in the Netherlands**

Shareholders who wish to vote at a general meeting of shareholders have to meet certain legal requirements. Dutch law was recently changed, and these changes affected shareholders rights. The most important changes were described in chapter 3.

For the purpose of this study we focus mainly on potential problems related to voting. Subsequently, we identify five main categories of impediments: voting agreements, stock lending, 'acting in concert', corporate governance issues/shareholder rights, and electronic voting.

With respect to the first category we conclude that voting agreements come in many varieties. A common element, though, is that a shareholder commits himself to exercise (or not) their voting rights in a certain manner. Three different types of voting agreement may be defined: (a) between the company and a shareholder, (b) between shareholders, and (c) between shareholders and third parties. Categories b and c are used in the Netherlands. One of the important questions relating to voting agreements is whether a shareholders' vote is valid when that vote has been cast in violation of a voting agreement. The generally accepted doctrine is that the vote is valid even if it has been cast contrary to a voting agreement. A party may require an irrevocable proxy from the other party before entering into a voting agreement, which is generally felt to be valid as long as the proxy is meant to ascertain that a certain action is being taken which is in the interest of the issuer of the proxy or a third party. Even when a shareholder has given an irrevocable proxy to a third party he is not prevented from attending the general meeting himself and casting his vote at that meeting. Obviously, the proxy holder is not allowed to vote in such a case.

Regarding the second category, lending, this is an increasingly important practice that should improve market liquidity. The word lending, however, has misled many since from a legal point of view the transaction is an absolute transfer of title against an undertaking to return equivalent securities (consistent with Dutch law). Misconceptions have led to loss of shareholders votes in important situations as well as to cases of shares being voted by parties who have no equity capital at risk in the issuing company, and thus, no long-term interest in the company's welfare. Corporate governance policies might be at risk, because of a lack of coordination with lending activity.

'Acting in concert' is the third category of impediments referred to. The Takeover Bids Directive provides that shareholders who obtain control over a listed company will have to make a mandatory offer to other shareholders. Because it is felt that the current regulations are not clearly specified to answer the key questions when shareholders abuse market rules and 'act in concert', shareholders might be reluctant to engage in shareholder activities. Acting in concert is also dealt with in the rules regarding the notification of major shareholdings. Section 10 of the Transparency Directive<sup>10</sup> has been implemented in article 5:45 Act on Financial Supervision and now provides that a shareholder should add to his own voting rights the voting rights held by a third party with whom the shareholder has concluded an agreement which obliges them to adopt, a lasting common policy towards the issuance of their voting rights.

The fourth category of impediments refers to the shareholder rights. The European Union agreed to a directive to ensure that shareholders have timely access to the complete information relevant to general meetings and that facilitates exercising voting right by correspondence and by proxy. Furthermore, it should abolish the main obstacles that exist in cross-border voting, i.e. share blocking, insufficient or late access to information, and overly burdensome requirements on distance voting, whereas the right to ask questions should be accessible to non-residents and voting results should be available to all shareholders and posted on the website.

Finally, the fifth category of impediments refers to the lack of a legal obligation to facilitate the use electronic voting.

#### **Main findings of our empirical study**

In chapter 4 we reported on the design and the results of our empirical research. Although the response to our survey can be seen to be low, we can still report some interesting and robust findings.

In order to facilitate the interpretation of our findings, we first reported on the composition of our sample. In general, pension funds by far outweigh other types of institutional investors, while there are about as many Dutch as international investors in our sample. The majority (59%) of the Dutch institutions are company or private pension funds; the second largest subgroup within the Dutch group consists of public or sector pension funds (25%). This is the other way around for the non-Dutch institutions, where the number of public pension funds (46%) is slightly larger than the number of private or sector pension funds (41%). In general, the pension funds in our sample have obligations that derive from defined benefit plans. Comparatively, Dutch pension funds are: (1) relatively smaller (2) have a smaller home bias in their investments, and (3) are less diversified than their international counterparts, while the average time horizon for all pension funds is roughly similar (about 42 months). The relative dominance of pension funds in our sample sets constraints on the conclusions that can be drawn from our empirical research. More specifically, our findings may not be representative for non-pension fund investors, particularly not for international non-pension fund investors. Within the group of pension funds, however, a meaningful distinction between Dutch and international pension funds can be made.

A first set of findings indicates that there may be an important ceremonial dimension to shareholder activism. This is manifest, first, in the responses to questions in our survey that we asked only Dutch investors. These questions pertain to the practice of lending shares to other investors. Apparently, this is a wide spread phenomenon in the Netherlands. A large majority of Dutch investors report that they lend shares to other investors (pension funds: 62%, other investors: 71%), and when they do, it involves a significant part of the portfolio (pension funds: 10%, other institutions: 15%). Yet at the same time, voting rights on shares lent are never retained by the lender, while shares are seldom recalled to vote and borrowers are hardly ever given instructions or required to provide assurance on instructions given. Moreover, we found from the interviews that lending desks often operate separately from the officers involved in voting. Thus although share lending is widely practiced, it seems hardly developed in regard to

<sup>10</sup> Directive 2004/109/EG.

shareholder activities. Perhaps this is an indication for the real importance that investors attach to voting. It also raises the question whether current practices regarding share lending are adequately institutionalised.

A second finding similarly questions the real importance to investors of shareholder activities. It involves the amount of resources dedicated to these activities. Consistent with other research, these were found to be small – around €100.000 – and spent predominantly on domestic investments. While the latter can be seen to be rational on account of the costs of shareholder activities increasing with distance (see below), the rather trivial amount of resources investors report to spend on shareholder activities indicates that there may be a significant ceremonial dimension to shareholder activities.

The risk of engaging in largely ceremonial shareholder activities, third, appears particularly high for international equity investments. For these shareholdings, proxy voting is about the most important, and often the only activity institutional shareholders engage in. We have indicated, however, that the dominant role of ISS in the market for international shareholder services that our interviewees report may constitute a mechanism through which highly isomorphic shareholder policies and activities result from very uniform company reports and voting recommendations. This can be seen to increase the risk of developing largely ceremonial shareholder policies and activities that have hardly any functional relation to the instrumental purpose that shareholder activism presumably has.

A fourth indication that there may be a ceremonial dimension to the shareholder activities of institutional investors involves the motives that investors report for targeting firms for shareholder activities. For both international and Dutch pension funds (albeit the latter to a lesser degree), corporate governance issues are reported to be the most important trigger for shareholder activities. This is a remarkable finding given that empirical research reviewed in this report has not been able to document any positive effects of shareholder induced corporate governance reforms on firm value. That investors focus on corporate governance issues nevertheless, is easily explained. Corporate governance issues are relatively easy to observe – e.g. they are reported on by shareholder services providers as ISS – and are also easier to remedy than underperformance of listed companies, for example. Yet in spite of it being understandable, the focus on corporate governance issues challenges the rationality of much institutional investor activism.

Another set of interesting findings pertained to the questions that aim to measure the frequency and perceived importance of different kinds of shareholder activities that institutional investors engage in. We found that investors are generally more active on domestic investments than they are on international investments. This finding corroborated the picture that emerged from the interviews. Domestic activism is not only more convenient, but it is also cheaper, particularly for activities for which the cost increases with distance, such as attending shareholder meetings or engaging in private engagements with portfolio companies. This general home bias in shareholder activism therefore need not signal irrational behaviour (see below). Moreover, international pension funds reported to be generally more active than Dutch pension funds, while they also reported higher frequencies on distinctively public shareholder activities. The Dutch pension funds, in contrast, revealed a distinct preference for private activities.

We found, second, that pension funds generally find shareholder activities more important than can be inferred from the frequencies with which they undertake these activities. Although this finding should be interpreted with caution, it demonstrates the insight that the availability of options for shareholder activities are typically found to be more important than engaging in these activities. This is particularly true for activities that seem to be low base-rate phenomena to begin with, such as calling an extra ordinary shareholder meeting. Hence one should be careful to infer from a low degree of shareholder activities that these activities therefore do not matter much, as they matter most under relatively rare conditions.

A number of interesting insights resulted from asking investors directly for the motives that drive them to engage in shareholder activities. What is remarkable is that the motives that intended to capture rational decision-making on engaging in shareholder activities scored low across the board. More specifically, this means that investors believe that measuring the costs and benefits of their shareholder activities is relatively unimportant in deciding whether or not to become active on their shareholdings. This finding is consistent with what we learned from the interviews and speaks against a rational assessment of shareholder activities by investors, even if we discount for

the methodological difficulties that frustrate measuring the benefits from shareholder activism. What is noteworthy, furthermore, is that Dutch pension funds reported to be driven mostly by considerations that intended to capture the symbolic and ceremonial dimension of shareholder activities, while the international pension funds reported to be motivated more by the considerations that underlie a rational cost-benefit analysis.

In the final part of our empirical research we have attempted to assess the relative effect of different factors on the degree of investor activism through a so-called regression analysis. A number of robust conclusions were drawn from this analysis:

1. Investors are generally more active in their home countries than in the foreign countries in which they invest. Although this is a remarkable finding, it can be seen as rational to the degree that shareholder activities become more expensive with distance. After testing whether this home bias applied to different kinds of shareholder activities, we found that it applies only for the kind of activities for which the costs increase with distance, such as attending shareholder meetings, or privately engaging with portfolio companies. The home bias can therefore largely be accounted for from a rational cost-benefit perspective.
2. Investors from the UK and Canada tend to be more active than investors from other countries. Although we provided no explanation for this finding, this may very well be because shareholder interests were voiced and organized much earlier in Anglo-Saxon jurisdictions than in the rest of the world.
3. The type of investor did not have a significant impact on the degree of shareholder activity. On account of the low number of observations in the non-pension fund investor category, however, this finding should be interpreted with caution.
4. Inversely to the theoretical expectations we summarized in chapter 2, we found that funds with obligations that derive from defined benefit pension plans are less active than funds with defined contribution pension plans. Apparently, the quality of monitoring on fund performance increases, rather than decreases, with the degree to which these funds have open ended obligations towards their beneficiaries.
5. Larger investors are more active. This pretty much confirmed the conventional wisdom according to which economies of scale and learning increase with size.
6. The three types of motives we have tried to operationalize – i.e. rational, cognitive institutional and normative institutional – were strongly interrelated, and always positively related to the degree of shareholder activity. Where these motives were made to compete, however, only the rational motives turned out to be a significant determinant of shareholder activism. This by no means concludes the issue whether shareholder activities are rational or whether they should be seen as largely ceremonial, even if only because of statistical and methodological limitations to our research. If anything, the results of the research reported here calls attention to this issue, which is relevant both for academics and practitioners.



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