



**SHADOW
FINANCIAL
REGULATORY
COMMITTEE**

COMMITTEE MEMBERS

GEORGE G. KAUFMAN
Co-Chair
Loyola University Chicago

RICHARD J. HERRING
Co-Chair
University of Pennsylvania

GEORGE J. BENSTON
Emory University

MARSHALL E. BLUME
University of Pennsylvania

CHARLES W. CALOMIRIS
Columbia University

KENNETH W. DAM
University of Chicago Law School

FRANKLIN R. EDWARDS
Columbia University

SCOTT E. HARRINGTON
University of South Carolina

PAUL M. HORVITZ
University of Houston

RANDALL S. KROZNER
University of Chicago

KENNETH LEHN
University of Pittsburgh

HAL S. SCOTT
Harvard Law School

KENNETH E. SCOTT
Stanford Law School

PETER J. WALLISON
American Enterprise Institute

Administrative Office
c/o Professor George Kaufman
Loyola University Chicago
820 North Michigan Avenue
Chicago, Illinois 60611
Tel: (312) 915-7075
Fax: (312) 915-8508
E-mail: gkaufma@luc.edu

Statement No. 204

For Information Contact:

Charles W. Calomiris
(202) 862-7151
Randall S. Kroszner
(202) 862-5878

Statement of the Shadow Financial Regulatory Committee

on

Enabling Institutional Investors to Play a More Effective Role in Corporate Governance

February 9, 2004

The SEC's recent proposals on "Shareholder Access" have generated an unusually large number of comments. As detailed in Statement No. 199, the Shadow Financial Regulatory Committee believes that the current SEC proposals would produce few, if any, benefits and have potential downside risks. Those proposals concern the ability of significant shareholders, under certain narrow circumstances, to include their candidates for directors in the proxy materials distributed to shareholders by a company. Rather than proposing a new set of complex regulations, the SEC, together with Congress and the Administration, should focus reform efforts on reducing barriers for the involvement of significant shareholders in the corporate governance of publicly traded firms.

The objective of any reforms of the corporate governance system should be to improve shareholder value. Re-examining the role that significant shareholders (institutional investors) can play in the governance process under current rules is important. In many cases, large institutional investors, such as index funds with large holdings in portfolio firms, do not have the option simply to "vote with their feet" by selling their holdings of firms that are underperforming. Particularly in these circumstances, it is valuable to investigate whether the current legal and regulatory system discourages useful involvement of institutional shareholders in monitoring and disciplining management.

An independent committee
sponsored by the
American Enterprise Institute

<http://www.aei.org>

When designing regulatory reforms to achieve meaningful and constructive engagement of institutional investors in the corporate governance of their portfolio firms, the SEC should begin by asking why institutions have not been more active in the past. If active involvement by blockholding institutions in corporate decision making is such a good idea, why haven't institutional investors pursued it more?

The Committee has identified several possible explanations, each of which points in a different direction for reformers seeking to increase institutional involvement in corporate governance.

First, it may be that regulatory limitations on the amount of stock in any one corporation that an institution is permitted to hold may reduce the incentive of an institutional investor to incur the costs of exercising a voice over corporate governance. These limitations apply to classes of institutional investors under various statutes, including state laws governing insurance companies, the Investment Company Act of 1940, banking laws, and financial holding company regulations.

Second, institutional investors may hesitate to play a role in corporate governance due to either regulatory limitations on their actions with respect to portfolio firms or legal risks that reduce their incentive to play an active role. Banks, for example, can face equitable subordination or lender liability when they are actively involved in corporate governance of debtor firms encountering distress. Also, any institution that places one of its own employees on the board of a company faces potential liability for insider trading or suits brought against that director. If these legal and regulatory impediments exert an important chilling effect on corporate governance by institutional investors, it might be appropriate to remove or reduce some of these limitations, or encourage market-oriented reductions of legal risks through mutual insurance of those risks by institutional investors.

Third, it may be that involvement by institutional investors in corporate governance has been hampered by difficulties in coordinating the behavior of several blockholding institutions holding shares in the same firm. A coordinated effort of many institutional investors, who together have a significant stake in a firm, might be much more effective as a means of exerting influence than the actions of one institution acting alone. Coordination, however, can be costly for two reasons: physical coordination costs and legal

impediments or risks to coordination. It is possible that some beneficial coordination is avoided out of fear that this would result in potential legal problems for institutional investors (e.g., through antitrust laws or section 16(b) rules governing short swing trades).

Fourth, it may be that the Williams Act and anti-takeover devices have weakened the incentive for institutional investors to play an active role in corporate governance. After all, the primary roles of institutional investors in corporate governance are occasional interventions to support a hostile takeover or to replace a dysfunctional board of directors, rather than to play an ongoing role in supervising day-to-day management decisions. If anti-takeover devices insulate management from the threat of such discipline, then institutional investors may conclude that there is little point to taking an active role in corporate governance. Here, the policy solution would focus largely on changes in law and regulation that would facilitate market discipline through takeovers.

Finally, it is possible that the lack of involvement in corporate governance by institutional investors is the result of agency problems between ultimate stockholders and the institutional investors that manage their shares. If pension fund and mutual fund managers face weak incentives to maximize the value of the portfolios they manage, they may choose not to be as diligent as they should be in improving corporate governance in portfolio firms. To the extent that agency problems in money management are an important problem, policy makers should consider ways to improve money managers' incentives.

The Committee believes that rather than attempt to enhance shareholder democracy by tinkering with shareholder voting rules, policymakers should focus on enhancing the ability of institutional investors to affect corporate governance.