

**26th Conference of the International Working Party on Segmentation Theory on
'The Dynamics of National Models of Employment'**

8-11 September 2005, Berlin, Germany

**Institutional Investors and Contemporary Corporate Governance:
Prospects for Enhanced Protection of Employee Interests in Liberal
Market Economies**

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Abstract

A striking feature of Liberal Market Economies (LME) is their 'market-outsider' system of corporate governance (Pendleton and Gospel 2004). The attendant features of this system include, market based financing, equity based incentives for senior executives and a focus on maximizing shareholder value in the short term. These features are considered hostile to employee interests in that they result in shorter job tenures, disinvestment in skills and training, a reluctance to deal with employee representatives and other cost minimization approaches to labour management. However, this paper examines several emerging trends in LME capital markets and corporate governance which may signal a retreat from extreme shareholder value ideology and the prospect of a financial and corporate governance context more favourable to the protection of employee interests.

Introduction

Shareholder value ideology is typically regarded as a key feature of liberal market economies (LMEs) in which market-outsider systems of corporate governance place primacy on maximizing returns to shareholders (see Hall and Sokice, 2001; Gospel and Pendleton, 2004). This approach to corporate governance has its theoretical roots in the nexus of contracts model of the firm developed by Jensen and Meckling (1976) and Fama and Jensen (1983). These finance economists insisted that agency costs could be minimized through, *inter alia*, the development of an active market for corporate control and the alignment of principal-agent interests through powerful equity-based incentive systems for senior managers. As Lazonick and O'Sullivan (2000) have explained, the influence of the agency theorists was felt in the 1980s and 1990s (especially in the United States) where there was an unparalleled growth in the corporate dividend payout ratio and

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share buybacks as a means to maximise shareholder returns. Moreover, Lazonick and O'Sullivan (2000) point to the number and size of corporate acquisitions, the extent of workforce downsizing and the significant growth in executive remuneration in this period as evidence of the influence of shareholder value ideology. Further contributing to the short term fixation on stock prices was the impact of large institutional investors who seemingly exercised ownership without responsibility, and whose only concern was pressuring management to maximize returns in the short term. While this view of the functioning of capital markets in LMEs may seem overly deterministic and may overlook the extent of managerial power and agency, the basic dynamic seems incontestable. This singular focus on shareholder returns has been particularly damaging to employee interests since it typically corrodes internal labor markets, is hostile to employee voice and representative structures, shifts risk to employees via contingent pay arrangements and fundamentally treats employees as a cost to be controlled rather than as a resource to be developed.

This paper contends that while shareholder value ideology is still a pervasive force within LMEs, recent and emerging developments in institutional investment¹ and corporate governance may provide greater protection for employee interests in the future. In particular, the paper identifies three market and institutional trends which collectively have the potential to reduce shareholder value pressure on employee interests and re-task management to build long term wealth.

The first of these emerging trends is the growing size of institutional investors' funds under management (FUM). The FUM of mutual funds, pension funds, insurance companies and banks has grown to such an extent that holdings are relatively illiquid – that is, institutional investors cannot reduce their holdings easily without affecting the stock price (see Deakin, 2005; McDonald, 2004). This phenomenon is increasingly leading to less active and more interested and long term oversight of management by institutional investors. Thus it is argued that some institutional investors in LMEs are becoming more like insider-relational investors (see Gospel and Pendleton, 2005). The second trend identified by the paper is the rise of socially responsible investment (SRI) which incorporates social, ethical and environmental concerns into investment decisions. SRI has been the fastest growing financial product in most industrialized countries over the last decade and there is evidence that its investment philosophy may encourage long term corporate wealth generation that is consistent with employee interests (see Waring and Lewer, 2004; Sparkes and Cowton, 2004). Finally, the paper reviews corporate governance developments in the United States, the United Kingdom and Australia in the post-Enron period. It argues that changes to corporate governance promoted by the corporate collapses and scandals of 2001-2003 complement a longer term investment horizon and emphasize governance structures that offer enhanced protection of employee interests.

These market trends and institutional developments are still emerging and their impact will clearly be uneven across various industries and national business systems. Nonetheless, it is argued that collectively, these developments serve as a counter-point to shareholder value ideology and help to produce pressures which are more

accommodating of progressive employment relations practices. The strengthening of these still-emerging developments however, is contingent on further regulatory change to reduce stock churning and encourage institutional investors to take a more active and responsible role in the governance of the corporations they own.

Institutional Investors: Turning Market-Outsider Relations Inside Out?

Approximately \$US118 trillion is invested in global capital markets according to a recent report by the McKinsey Institute published in February 2005. Global financial stock (calculated as the total amount invested in equities, public and private debt and bank deposits) more than doubled in the ten year period from a figure of \$53 trillion in 1993 to \$118 trillion in 2003 and has consistently out-paced the growth in world GDP. Indeed the MCGI report states that ‘Between 1993 and 2003, the global financial stock grew on average at 8.4%, more than twice as fast as the growth in global GDP of 4%’. Equities have grown faster than the overall financial stock and are worth some twenty-eight per cent of global financial stock (MCGI, 2005, p13). By 2010 global capital markets are expected to reach \$209 trillion in value.

Perhaps unsurprisingly, the USA holds the largest share of global financial stock at 37 percent (\$44 trillion) with Euro-zone markets second with 31 per cent (\$37 trillion) followed by Asia with 23 per cent (\$27 trillion) (MCGI, 2005, pp61-63)

The following table 1 shows the composition of financial stock in these capital markets.

Table 1 Composition of Financial Stock in Large Capital Markets

| | Equities | Private Debt | Government Debt securities | Bank deposits | Total (in Trillions) |
|----------------------|-----------------|---------------------|-----------------------------------|----------------------|-----------------------------|
| United States | 14.5 | 15.8 | 5.2 | 8.8 | 44 |
| Euro-zone | 4.9 | 7.5 | 5.4 | 7.7 | 25.7 |
| Japan | 3.0 | 2.1 | 6.2 | 6.3 | 17.6 |
| UK | 2.4 | 2.1 | 0.5 | 1.9 | 6.9 |

Source (Derived from MCGI, 2005)

A significant trend in the market for equities securities is the growth of institutional investors (Pension funds, banks, Insurance companies and mutual funds) that now hold the majority of outstanding equities securities). This trend has been worldwide but it is more pronounced in the highly developed equities markets of liberal market economies. In the UK institutional investors have always historically been more important than individual households as shareholders and who collectively own 50% of all UK shares compared with individual investors who hold 14.8% (Eurosif, 2003:4)

In the United States, over 50% of equities are held by institutions (See English et al, 2004, p157) and there is a strong trend towards household's preferring to hold stock indirectly through institutional investors such as pension and mutual funds. According to the Investment Company Institute (a premier mutual fund association in the US with 8,459 mutual fund members) 48.1 per cent of US Households had invested in mutual funds up from just 5.7 % in 1980 (ICI, 2005).

Although there are approximately 8,459 mutual funds operating in the US the top 25 mutual fund families together have 74% of the \$8.2 trillion in mutual fund assets and it seems the trend is towards long term investing according to the Investment Company Institute. It claims that 'U.S. households' growing reliance on stock, bond, and hybrid mutual funds in part reflects many investors' desire to use funds to meet long-term investment goals such as preparing for retirement' (ICI, 2005).

Unsurprisingly, these trends have proved to be a significant driver of net cash flow to mutual funds. As Table 2 shows, three large US mutual funds growth is typical of that experienced in the collective investment scheme industry between 1995-2004. In 2004 alone, the Investment Company Institute (2005) has calculated that net new cash flow (new cash flow minus cash outflow in the form of payments and redemption) to mutual funds was in the order of \$US221 billion. The determinants of the flow of capital to institutional investors are complex and multifaceted but tend to include fund reputation, whether funds manager exceed the index, the magnitude of out-performance and the size of funds. In general terms though, higher share prices and a distinct household preference for extracting economies of scale by pooling investment funds, are chiefly responsible for substantial the rise in mutual fund assets.

Table 2 Three US Mutual Fund's Growth 1995-2004 (in \$US billion)

| | Fidelity | Vanguard Group | American Funds |
|-------------|-----------------|-----------------------|-----------------------|
| 1995 | 269.49 | 150.15 | 135.01 |
| 2004 | 651.86 | 671.86 | 549.17 |

Source: Financial Research Corp (2004)

Mutual funds invest in a range of instruments such as government debt securities and bank deposits, real estate and so on but the vast majority of funds tend to be invested in equities. Indeed the ICI (2005) indicate that 49% of mutual fund assets (\$US3.68 trillion is held in equities securities)

Mutual fund growth has been mirrored by the tremendous growth in private pension funds around the globe. The OECD (2005, p5) has recently estimated that the value of pension fund assets in the OECD has grown from 29% of GDP in 1987 to 61% in 2003.

Table 3 Pension Fund Asset Growth in Selected Liberal Market and Coordinated Market Economies (in \$US trillions)

| | 2001 | 2003 | % of GDP |
|-----------------------|------|------|----------|
| United States | 6.7 | 7.2 | 66 |
| United Kingdom | 1 | 1.2 | 65.7 |
| Japan | .56 | .56 | 13.1 |
| Germany | .062 | .085 | 3.6 |

Source: OECD Pension Markets in Focus, (2005)

As table 3 shows, the growth has been most marked in liberal market economies and less so in CME's where state provided pensions remain important. In the UK, 53.8% of pension fund assets are held in equities while the figure for the United States is lower at 29.3% it remains the largest asset class (OECD, 2005, p7).

The tremendous growth in pension fund and mutual fund assets means that these institutional investors have become increasingly powerful actors in equities markets. As a result of this growth, holdings have become more concentratedⁱⁱ and where as managements for much of the twentieth century have tended to face fragmented and widely dispersed stockholders, they now face, in many cases, an identifiable group of portfolio managers and there is little evidence of this trend abating (see Useem, 1996; Clark and Hebb, 2003). Indeed Clark (2004, p16) has suggested that “further concentration in the industry around global financial institutions seems to be inevitable. They are increasingly like giant vacuum cleaners sucking up geographically dispersed money into concentrated pools of finance...’

The sheer size of these holdings makes funds management a more difficult and potentially riskier exercise. Xinge (2004, p1868) for instance cites research which suggests that fund performance tends to deteriorate when a fund ‘exceeds its optimal size’ due to the higher costs associated with researching and trading for a large fund. Importantly though, Xinge also suggests that ‘portfolios of larger sizes tend to have higher average trading costs because the trading of large blocks of stocks has tremendous adverse impacts on stock prices by bidding up prices when buying and driving down prices when selling’. In other words, the costs associated with *active* funds management increase considerably with size and encourage more *passive* (buy and hold) approaches.

Some mutual funds are inclined to close to new investors as their fund reaches what they consider to be its optimal size. But closing a fund to new investors may prove to be counter-productive as it tends to signal to investors the superior performance of the funds manager and guarantee higher capital inflows to the funds managers’ family of mutual funds. Xinge (2004) suspects this is the true motivation of closing a fund. Other funds managers may attempt to broaden their portfolio’s to mitigate some of the difficulties associated with concentrated holdings. However, broadening a portfolio tends to also

increase the management expense ratio of a fund. Moreover, there is some evidence to suggest that broadening a portfolio may not lead to strong fund performance.

Kacperczek et al's (2003) analysis of the performance of actively US mutual funds between 1984 to 1999 reveals that funds with more concentrated industry holdings outperformed fund managers with broad portfolio's. Their explanation for this finding is that funds managers with concentrated holdings have informational advantages over those without dispersed holdings. This is an important finding as it directly disputes portfolio theory's notion that risk adjusted returns are higher when investments are spread over a range of sectors and firms.

The capacity therefore, of large institutional investors to exit a company (selling their holdings and performing 'the Wall St walk') is therefore much diminished with the growth and concentration of holdings. This leaves pensions and mutual funds with two remaining strategies - voice or loyalty (see Hirschman, 1970). In other words, funds managers may demonstrate loyalty to management of the companies they invest in by abdicating ownership responsibilities or they can develop relationships with management and voice their concerns. Either strategy implies less turnover of holdings and a longer term investment outlook. A longer term investment outlook is also consistent with the broad objective of Pension Funds which is to seek risk-adjusted returns on their investment that match or exceed growth in averages wages. Hence Pension funds tend to be more risk averse and more long term value investors (Davis, 2001).

Such an approach is exemplified by perhaps the most famous of pension fund managers, the California Public Employees' Retirement System (CalPERS) who state on their website:

'We are long-term investors - we buy and hold. Our belief is that the market is efficient and that our long-term investment strategy will win over time. In our view, patient money is smart money.' (CalPERS, 2005)

With \$US190 billion in funds under management, CalPERS has become a relationship investor, seeking to improve the value of its investments by exercising voice in the companies that it holds stocks in. In the main, CalPERS attempts to improve the quality of corporate governance in the companies it invests with through engagement with and monitoring of management. However, it also has a policy of publicly naming companies it believes have poor corporate governance.

English et al (2004) point to some evidence that this activism generates above average returns from the companies that are targeted by CalPERS although only for a certain period after the announcement that they are being targeted. Wu's (2004) research on the effects of CalPERS activism discovered that companies are likely to decrease the number of insider directors on their boards and these ex-directors are less likely to take up directorships elsewhere. Moreover, Wu found that the likelihood of CEO dismissal increases after their company has been publicly targeted by CalPERS.

The success of CalPERS 'inside-relational' approach has been reproduced by many other large pension and mutual funds around the world. In the UK for instance a long-term engagement approach has been most clearly exemplified in the work of Hermes Investment Management Ltd, one of the UK's largest private pension funds managers (Armour et al., 2003; see also Clark and Hebb, 2004).

The growing propensity of institutional investors to employ insider-relational investment techniques such as monitoring and engagement coupled with a longer term performance orientation that stems from large, concentrated and relatively illiquid holdings suggests a context which may be more favourable to the practice of progressive employment practices. A longer term investment orientation reduces pressure on management to secure short term gains through undue head count reductions and may create an environment less hostile to the investment in skills, training and internal labor markets. Arguably then, the elements of market-outsider systems which are prevalent in LME's may be tempered by the emerging tendency towards insider-relational investing – thus having the consequence of turning market-outsider systems insider out.

Clark and Hebb (2003) have described the rise of this type of institutional investment as the 'fifth stage of capitalism'. They contend that Drucker's (1976) view that the growth of pension funds would bring about a new form of socialism was misguided and instead argue that the growth of pension funds in particular, produces a reconfigured capitalism in which aggregated and concentrated holdings allow and direct funds managers to engage with management to create value over the longer term. Clark and Hebb (2003,p11) assert that although in the past, such monitoring and engagement was costly and subject to 'free rider' concerns, the sheer size of pension funds means that 'they are able to bear these costs alone or in coalition with other institutional investors'. Moreover, they argue that the loss of half a trillion dollars in the corporate collapses between 2001-2003 in the United States has created a stronger impetus to more closely scrutinize management activity. Furthermore, once engaged with Management, Clark and Hebb argue that they are more likely to see what business fundamentals drive wealth creation.

There is an important corporate governance debate however, as to whether relationship investing is likely to occur even with ever enlarging and more concentrated holdings. Clearfield (2005, p114) has argued that institutional investors do not like voting against incumbent managements and has cited a number of reasons for this reluctance including, the free rider problem, reputational risks (institutions do not always want to be known as activists, costs, and relationship risks (portfolio managers might decide their longer term interests lie with management).

Similarly Ingley and van der Walt (2004, p540) cite Bies (2003) who suggests that some funds manager are reluctant to engage in activism because it might impinge on commercial relationships they have with corporate clients and which encourage passivity. An example of such a conflict is provided by Monks (2002) who draws attention to the HP-Compaq merger in which institutional investors held a legal obligation to act in the best interests of pension fund participants but that this was

sometimes in conflict with their commercial interests to maintain their relationship with HP as a valuable client.

Clearfield (2005, p118) also points to structural reasons why funds managers may be reluctant to become active in monitoring corporate governance arrangements. He contends that corporate governance specialists are normally from legal backgrounds and are not always able to convince portfolio managers as portfolio managers tend to be numbers driven and enjoy higher occupational status than governance specialists. Further, he argues that corporate governance specialists and portfolio managers tend to compete for corporate attention which reduces any impetus on behalf of funds managers to engage in monitoring of CG. Moreover, he argues that the time horizon of portfolio managers tends to be short for corporate governance campaigns to be effective.

Even if institutional funds managers can be considered to be insider-relational investors this may not signal the end of managerial capitalism as managers may be able to astutely 'manage' investor relations. Useem (1996) argues that management are able to retain a degree of agency even when confronted with activists owners. On the other hand, management are also clearly anxious to ensure that institutional investors remain satisfied with their performance – especially where they are incentivised with stock options.

The question of whether pension and other institutional funds managers effectively monitor and engage management is keenly debated in the literature and both sides are able to produce reasoned argument and some anecdotal evidence to support their side but the rigorous empirical research required to resolve this question has not yet been produced. In any case it is likely that there are examples of effective insider-relational approaches and cases where funds managers are derelict in exercising ownership responsibilities. It must be remembered that institutional investors are not a single homogenous group but rather have a variety of interests and investing philosophies. However, there is evidence that increasing growth and concentrated holdings encourage many institutional investors into 'voice' rather than 'exit' strategies (see Useem, 1996, Clarke and Hebb, 2003, Gospel and Pendleton, 2005) and that 'voice' strategies coupled with a longer term investment orientation is less likely to be hostile to IR/HRM strategies which see people as a resource to be invested in rather than a cost to be controlled. Allied to the trend towards long term investment and corporate engagement by institutional investment is the adoption of social, ethical and environmental criteria by some institutions. Applying this non-financial criteria to investment decisions was once the domain of fringe Socially Responsible Investment funds but it is increasingly becoming an orthodox investment approach as a result of demand from pension fund beneficiaries and the strong desire to mitigate investment risks. These developments are discussed in the next section.

Socially Responsible Investment: Refracting Shareholder Value Ideology?

Socially Responsible Investment (SRI), defined as investments which incorporate social, environmental or ethical criteria as well as financial objectives, has been labelled by Sparkes (2002) as a ‘global revolution’ and there is widespread empirical evidence of growing interest and participation in SRI debt and equity instruments. From humble beginnings as an investment philosophy championed in the main by the Christian churches, SRI has grown in popularity and size and is widely considered to be a positive force within global capital markets and a key driver of Corporate Social Responsibility (CSR) (see Sparkes and Cowton, 2004; Michelson, et al, 2004). There is now a significant body of finance literature that has assessed the financial returns of SRI and the profile of SRI investors and there is an emerging consensus that SRI enjoys returns at least as good as ordinary investing (see AMP, 2005; Orlitzky, 2003).

Table 4 - A Comparison of SRI Funds Under Management (FUM) in The United States, the United Kingdom, Australia, Japan and Germany

| Country | Size of SRI FUM (equities) in Home Country Currency | Size of SRI FUM (equities) in Euro (as at 29 April, 2005) | SRI FUM (equities) as a % of GDP |
|------------------------|---|---|----------------------------------|
| US ⁱⁱⁱ | \$US 2.332 trillion | 1,800 billion | 19.83 |
| UK ^{iv} | £224.5 billion | 331 billion | 22.40 |
| Australia ^v | 21.3 \$Aus billion | 13 billion | 2.66 |
| Japan ^{vi} | 100 billion yen | 0.734 billion | 0.0002 |
| Germany ^{vii} | €7.7b* | 7.7 billion | 0.004 |

Source: Waring and Edwards (2005)

As table 1 indicates, the United States has by far the most funds invested according to SRI principles followed by the UK. The relatively small SRI presence in Germany and Japan has been explained by Waring and Edwards (2005) as a result of their less developed equities markets and the history of public provisioning of pensions in these countries. However, Waring and Edwards (2005) have also suggested that the long history of social regulation (especially regulation of labour markets) and the stakeholder approach typically taken to enterprise management may have also reduced the perceived need for SRI. Conversely, the strong presence of shareholder value ideology in liberal market economies may have encouraged the development of SRI as a counterpoint.

The last few years have witnessed significant growth in the size of SRI funds invested in the United Kingdom. According to the UK Social Investment Forum, the value of funds in socially responsible investments rose tenfold between 1997 and 2001 and is now worth some 331 billion euros. Arguably, the most important driver of this growth has been the introduction of the *SRI Pensions Disclosure Regulation* in 2000 – an amendment to the UK’s pension fund laws - which requires all pension funds to declare the extent to which SRI principles influence their investment strategy (see Sparkes, 2002:389). Similar

regulations were introduced in Australia (under the *Financial Services Reform Act 2001*) which require investment product disclosure statements to include ‘the extent to which labour standards or environmental, social or ethical standards are taken into account in the selection, retention, or realization of the investment’ (ASIC, 2002).

SRI growth in the UK has been underpinned by other developments. For instance, under the *Trustees Act 2000*, the trustees of charities are required to ensure that their investments are *suitable* - not simply in financial terms but also that their investments incorporate relevant ethical considerations. The creation of the FTSE4GOOD group of sustainability/CSR indices in 2001 has also encouraged greater interest in SRI. These regulatory drivers have been matched by a substantial rise in the number of UK insurance companies applying SRI screens to their equities investments as a result of the Association of British Insurers publishing new guidelines in 2001 that ask companies to report on material social, environmental or ethical risks (SEE) (Eurosif, 2003).

In the United States, institutional arrangements may have also assisted the growth of SRI and may be considered to contribute to its effectiveness. First, the US Securities and Exchange Commission (SEC) provisions allow shareholders who hold more than \$2,000 worth of stock (held for more than a year) to file shareholder resolutions. These provisions have helped to develop a culture of shareholder activism in the United States which is more developed than in other LMEs. The majority of Corporate Social Responsibility (CSR) resolutions are filed by SRI funds, the ICCR and the AFL-CIO (sometimes in collaboration with pension funds that have union trustees) (Social Investment Forum, 2003). Although most resolutions fail to pass (see Haigh and Hazelton, 2004), they often receive sufficient support to highlight certain issues or to influence management to reconsider certain CSR issues. Moreover, Domini (2001) argues that many resolutions are withdrawn prior to shareholder meetings because agreement is reached between the filer and management. The second and related complementary institutional arrangement concerns the nature and *modus operandi* of US pension funds. These bodies are required under the *Employee Retirement Income Security Act 1974* to use the voting rights attached to the shares they hold. This means they are more likely to take an interventionist perspective that is typically more complementary to SRI. More recently, the Social Investment Forum (2003) has argued that improved corporate disclosure regulations and closer scrutiny of corporate governance arrangements as a result of the *Sarbanes-Oxley Act (2002)* and new SEC regulations may provide an enhanced regulatory environment for SRI funds to improve their effectiveness.

While these institutional arrangements are arguably supportive of SRI and may enhance its effectiveness, this is often out-weighed by more prevalent features of US capital markets which combine to produce volatility in ownership and an orientation towards short-term and myopic investment practices that are not conducive to the incorporation of CSR principles (see Lazonick and O’Sullivan, 2000). Furthermore, while US pension funds are the largest single source of capital (worth \$7-8 trillion) only around eight per cent of this is established under ‘labour-management or jointly trusteesd pension plans established under the *Taft-Hartley Act* which requires equal representation of employees

and employers on the board of trustees' (Ghilarducci, 2001:165). This means that the majority of US pension funds lack the worker influence and control which might otherwise be supportive of an SRI philosophy.

Some recent research (Waring and Lewer, 2004; Haigh and Hazelton, 2004) has suggested that SRI may influence corporate governance through three mechanisms. First, the growth of SRI may raise the cost of capital to socially irresponsible firms; that is, SRI funds exclude investing in these firms, thereby making it more difficult and expensive for firms to raise capital and applying pressure on management to improve their CSR efforts. Second, SRI funds stress the exercising of shareholder rights to 'voice' rather than simply 'exit', potentially bringing significant change to those national systems which tend to rely on the latter. This voice may include direct dialogue with management or involve the use of shareholder resolutions. Third, SRI may seek to effect change by exploiting existing sensitivities over corporate reputation. Haigh and Hazelton (2004) have argued that SRI's relatively small size compared to the total size of global capital markets means that SRI is highly unlikely to affect the cost of capital significantly. This means that the second and third mechanisms are more likely to be effective in producing concrete changes to corporate governance. Waring and Edwards (2005) have argued that SRI needs to be embedded within a supportive institutional context (for instance complementary corporate governance regulations and strong institutional investment sector) for the second and third mechanisms to maximise their utility.

According to Waring and Edwards (2005), these mechanisms may impact on firm-level employment relations in a variety of ways. First SRI may help to create 'ethical space' in which human resource management practitioners can build persuasive arguments for the implementation of progressive people management policies such as investing in employee capabilities. For instance, SRI holdings that emphasise the legitimacy of various stakeholders might permit HR executives to build and maintain joint consultative arrangements with employee representatives. Second, where SRI heightens sensitivities over corporate reputation, management may choose to avoid industrial disputes by adopting pragmatic approaches to industrial relations. Third, SRI engagement strategies may encourage management to work within rather than challenge existing labour market institutions and regulation and may persuade firms to adopt proactive policies on issues such as supply chain labour conditions.

Although some observers, such as Haigh and Hazelton (2004) have correctly pointed to SRI's relatively small size as weakening its potential to influence firm behaviour, there is increasing evidence that SRI principles are becoming more 'mainstream'. That is, that environmental, ethical, human rights and labor principles are being adopted by mainstream investors and creditors as part of more sophisticated risk management. As noted earlier, the UK Association of British Insurers are requesting that companies disclose material risks across social, ethical and environmental issues. Their interest in doing so stems not simply from some kind of enlightened capitalism but because these issues represent real risks especially with the growth and distributed operations of corporations. For Pension funds^{viii}, an additional driver is demand from their beneficiaries for SRI portfolio choices. Amalric (2004, p1) for instance cites a Canadian poll which

found that 51% of those surveyed wanted their pension funds invested in companies with good CSR records. For most institutional investors, however, their concerns go beyond the possibility of prosecutions or consumer boycotts and importantly include the loss of reputation that inevitably accompanies poor corporate citizenship.

Clarke and Hebb (2004) have argued that institutional investors are increasingly incorporating reputational risk indicators into their investment analysis metrics due to the growing importance of the nexus between firm reputation and earnings. Further, Clarke and Hebb (2004) argue that because global brands are so essential to multinational company earnings, and are so expensive to develop and maintain, that institutional investors are concerned whenever an event occurs which threatens to tarnish the brand or firm image, and therefore future earnings. Hence, institutional investors are placing pressure on managements to ensure that CSR issues are addressed and reputational risks are mitigated. They also contend that a good reputation signals to capital markets 'that value is likely to be preserved and enhanced in the future' (Clarke and Hebb 2004, p11). Importantly, their argument distinguishes between companies that are light on tangible assets but heavy on intangible assets. This may also be described as the difference between the book value of a corporation and its market capitalization – this difference tends to be larger in firms where intangible assets are critical to earnings than in firms with more tangible assets. Clarke and Hebb (2004) assert that reputational risks tend to be greater in companies with more intangible assets such as global brands since they rely on positive consumer sentiment which can retreat with poor publicity or civil society activism. However, I would argue that corporate sensitivity is not only linked to brand image and thus companies that tend to be asset-light. Rather I would contend that corporate sensitivity to these issues is a more complex function of ownership structure, the importance of a firm's social license to operate as well as brand and firm reputation.

Nonetheless, Clark and Hebb's analysis provides a robust commercial reason for institutional investors to adopt SRI practices. Furthermore, it potentially gives rise to a context in which SRI funds are more likely to find allies in the rest of the investment community to work with them to ensure labour standards for instance are observed.

Corporate Governance Developments in Liberal Market Economies: A Detectable Shift to Stakeholders and a Long Term Orientation?

That markets and joint-stock companies are apt to fail from time to time is a recurring truth in the history of capitalism. Failures of corporate behemoths in the jurisdiction that arguably, most closely resembles the contractarians' ideal type (the United States of America) have led to a reappraisal and re-regulation of corporate governance in that country (see Watkins, 2003, Coffee, 2004 and Gordon, 2002 for a review).

During the euphoric market conditions of 1990s when the Anglo-American market-outsider system of corporate governance seemed superior to the relational-insider models of Japan and Germany, Bainbridge (1997) wrote,

“minimizing state regulation of corporate governance is essential to the preservation of a free, yet virtuous society. Viewed from a sphere sovereignty perspective, subordination of economic institutions to the state poses a grave threat to personal liberty.”

This was a commonly shared view of corporate governance observers in the US at this time. Unfortunately, neither these observers nor Bainbridge possessed a prescience of the corporate failures that would emerge in 2001-2003 that led to thousands of employees losing their jobs and often their life savings (see Clarke, 2004:321). It these failures of corporate governance and their underlying causes which have done much to dispel the article of faith expressed by Bainbridge (above) that the minimization of state regulation is somehow necessary to preserve freedom and virtue in civil society and which has been the catalyst for debate around re-regulating corporate governance in the US.

Much of the debate in the US has focused on the causes of the most significant of these failures – Enron – a company that had a market capitalization of \$US80 billion in October 2000 (Gordon, 2002:322) but which filed for bankruptcy in 2001 after a whistleblower drew attention to the company’s off-balance sheet activities that essentially hid enormous liabilities. That the market at one time priced Enron’s shares at sixty times its earnings and continued to support a high price in the months before its collapse has provided ‘another set of reasons to question the efficient market hypothesis’(Gordon, 2002:323).

The failure of the company and the market and investors inability to foresee the impending disaster has led observers to claim that the confluence of poor managerial ethics, perverse incentive arrangements, the complicity of corrupt and conflicted auditors, the herding behaviour of analysts along with a low risk environment created by reduced regulation were responsible. Coffee (2004:341) in particular points to the ‘judicial and legislative shift towards deregulation in the 1990s’ which ‘appreciably reduced the risk of liability’ for auditors. Furthermore, Coffee (2004:335) claims that ‘deregulation facilitated both the use of equity compensation and the ability of managers to bail out at an inflated stock price’. In particular he cites the relaxing of rules under the *Securities Exchange Act of 1934* which permitted managers and directors to exercise options without holding them for the ‘previously required six month period’ (p343).

In the wake of the collapse of Enron, WorldCom, Arthur Anderson, Tyco International amongst others, regulators introduced the *Public Company Accounting Reform and Investor Protection Act of 2002* (the Sarbanes-Oxley Act) and in doing so, reversed a decade-long trend of deregulation (Coffee, 2004). The *Sarbanes-Oxley Act*, *inter alia*, introduces a Public Company Accounting Oversight Board, that is independent of the auditing industry and will ensure that auditors do not also supply other services such as consulting services to clients that could produce conflicts of interest. Moreover, although Coffee (2004, p346) argues that the Act does nothing to ‘reduce the perverse incentives created by the unconstrained use of stock options’, a new accounting standard introduced by the Financial Accounting Standards Board (FASB Statement No. 123 Share-based Payment) will require all US listed companies to expense stock options from first quarter

2006. The expensing of stock options is likely to reduce their use in executive remuneration and hence one of the key drivers of the 'short-termism' experienced in the 1990's. Coffee (2004, p335) notes that equity-based compensation for CEOs in US public corporations went from 5% of their total compensation to 60% by 1999. This FASB accounting standard is expected to help reign in the excessive use of stock options, and with it, the short term managerial behaviour considered to be damaging to employee interests.

According to Jacoby (2005) these regulatory changes and the evolving corporate governance debate signals a significant retreat from the extreme contractarianism reached in the late 1990s and early part of the twenty-first century. He notes the emerging consensus that market-outsider approaches to governance can lead to 'rent-seeking' behaviour and loss of returns to share and other stake-holders. The expensing of options, new regulation, calls for greater corporate transparency and growing skepticism of the benefits of an active market for corporate control are signs of this withdrawal according to Jacoby.

Developments in the US have been matched by a detectable shift in corporate governance thinking in the United Kingdom and Australia. Liberal market economies' corporations law have rarely been informed by stakeholder theory (see Blair, 1995, pp.179-180 for several exceptions) however in the UK and Australia there have been some minor steps towards encouraging a stakeholder approach. In Australia, the Australian Stock Exchange (ASX) released in 2003 its ten best practice corporate governance principles of which Principle 10 'Recognise the Legitimate Interests of Stakeholders' holds the most promise for encouraging a stakeholder approach. The associated commentary on this principle states that 'there is growing acceptance of the view that organizations can create value by better managing natural, human, social and other forms of capital' (ASX, 2003:59). This principle calls upon boards to develop corporate codes of conduct which recognize and protect interests of stakeholders and specifically mentions employment practices as one important aspect for inclusion in a best practice code of conduct.

In the United Kingdom, there have also been some initial moves away from shareholder value ideology towards encouraging a stakeholder approach. Deakin (2005, p12) for example cites the Company Law Review Steering Committee's call for an 'enlightened shareholder value' approach where shareholder interests would be balanced with 'the need to sustain effective ongoing relationships with employees, customers, suppliers and others; and the need to maintain the company's reputation and to consider the impact of its operations on the community and the environment'.

Further, the UK based International Corporate Governance Network (a voluntary association whose members control \$10 trillion in FUM) has released a statement on Institutional Shareholder's Responsibilities. The statement states that the general objective of institutional investment should be the creation of long term value through institutional owners taking an active interest in their ownership responsibilities. These responsibilities according to the statement include, *inter alia*, using voting rights, communicating with the board regularly on corporate governance matters, submitting

resolutions to shareholders meetings. The statement goes on to say that while management are responsible for the day to day management of the company, it is the institutional investors direct responsibility to follow up on concerns that may affect the long term value of their investment including the management of environmental, social and ethical risks (ICGN, 2005, p2).

Complementing these principles are the ICGN's eight corporate governance principles which were revised in July, 2005. These principles embody the view that, shareholders should look to creating long term value. Moreover, principle seven goes to corporate citizenship and states:

'7. CORPORATE CITIZENSHIP, STAKEHOLDER RELATIONS AND THE ETHICAL CONDUCT OF BUSINESS

7.1 Board Responsibilities and Duties in Relation to Stakeholders. The board is accountable to shareholders and responsible for managing successful and productive relationships with the corporation's stakeholders. The ICGN concurs in the view that active cooperation between corporations and stakeholders is essential in creating wealth, employment and financially-sound enterprises over time.

7.2 Compliance with Laws. Corporations should adhere to all applicable laws of the jurisdictions in which they operate.

7.3 Disclosure of Policies. Corporations should disclose their policies on issues involving stakeholders.

7.4 Employee Participation. Corporations are encouraged to develop performance-enhancing mechanisms which align employee interests with shareholder and other stakeholder interests. These include broad-based employee share ownership plans or other profit-sharing programs that are designed to enable employees to share in improved returns to shareholders.

7.5 Corporate Social Responsibility. Corporations should adopt and effectively implement a code of ethics and should conduct their activities in an economically, socially and environmentally responsible manner.

7.6 Integrity. The board is responsible for determining, implementing and maintaining a culture of integrity.'

Source(ICGN, 2005,
http://www.icgn.org/organisation/documents/cgp/revised_principles_jul2005.php)

These principles clearly advocate the need for a longer term governance outlook which incorporates the interests of stakeholders, however, further empirical research needs to be conducted to examine their real industrial consequences.

Concluding Thoughts

Shareholder value ideology is a pervasive force in liberal market economies and this has resulted in the subordination of employee interests in favour of short term profit maximization. But there are some emerging signs that the ideology's dominance may be in retreat as a result of the confluence of capital market and corporate governance developments. These include the relational-insider investment approaches that are steadily being adopted by large institutional investors and the 'mainstreaming' of SRI principles which are in turn, complemented by regulatory developments designed to improve corporate governance arrangements. Theoretically, the collective effect of these developments is to provide a more favourable context in which progressive employment practices may emerge. For instance, the longer term orientation provides the patient capital required for investment in employee skills and training while the adoption of core labour standards may result in greater tolerance of employee voice and representative structures and improved wages and conditions up and down supply chains.

It would of course, be fanciful to assume that these trends will transform the governance and labour management practice of every public corporation within LMEs. Aside from the debates (noted earlier) regarding whether large institutional investors are interested or capable of requiring management to adopt a long term outlook, there is still significant funds invested to achieve above average returns in the short term. The considerable growth of Hedge funds (see SEC, 2003), for instance, places pressure on firms to perform in the short term- although it should be noted that hedge funds assets are a fraction of pension and mutual funds and insurance companies at just \$US650 billion (SEC, 2003, vii). Moreover, Monks (2005) has argued that there is still considerable stock churning despite a trend towards long term holding. He suggests that straightforward policy devices like taxing realized gains on institutional investor holdings of less than six months should be contemplated.

Nonetheless, these contrasting developments draw attention to the need to understand the structure of ownership of public corporations to be able to comprehend the pressures on governance and their likely effects on employees. It also points to the likelihood of considerable corporate governance diversity within LMEs – some companies will embody market-outsider approaches but others will reflect a relational-insider arrangement for the reasons already discussed.

The analysis of these trends might also indicate that Hall and Sokice's (2001) prediction that the internationalization of finance will place pressure on the institutions of CME's is too pessimistic. As discussed in this paper, the development of private pension funds and SRI might temper shareholder value pressures and prove to be consistent with the stakeholder orientation of CMEs.

Finally, it must also be remembered that managers retain considerable agency and there is not an unfettered line of causality between the objectives of owners and the management of the enterprise (see Useem, 1996). Aside from management's capacity to manage investor relations in their interests, they also have alternative sources of finance which

may make them less beholden to shareholders. All of this points to the need for rigorous empirical studies (case study and surveys) which examine the effects of various ownership structures on corporate governance arrangements and labour management practices.

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ⁱ The term institutional investor refers to pension funds, mutual funds, insurance companies, banks and other collective investment schemes (ICGN, 2005, p1).

ⁱⁱ It should be noted that under US ERISA 1974, Pension funds cannot hold more than 10% of a company.

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^{viii} According to Almaric (2004, p3) 30% of the UK’s largest 500 Pension funds have so far adopted SRI principles.