Despite the problems caused by separation of ownership and control, institutional investors and non-executive directors can be relied upon to monitor and control effectively the activities of management. Discuss.

by

Victoria Jones LL.B

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Berle and Means first introduced the idea of separation of ownership and control in 1932[1]. They identified the situation in the UK whereby the need for capital in larger companies was leading to the situation where no individual shareholder held a large or significant percentage of shares. This dispersion of capital among an increasing number of small shareholders has consequently led to a weakness of control by these shareholders over the activities of management; this is as a result of the 'logic of collective action'[2]. As individuals, shareholders lack time, money and experience to make full use of their rights as shareholders and tend to pay little attention as long as there are satisfactory dividends.

It was seen as rational to shareholders to remain inactive as individually their vote was unlikely to affect the success or failure of a resolution and so the only way to have an impact would be to vote collectively but the cost to one shareholder in organising this collective action would outweigh the benefits and enable a 'free rider' situation where the other shareholders would not incur any costs. Such shareholder apathy has meant that 'exit' rather than 'voice' has been the preferred response by a shareholder who is not satisfied with the management of the company. The result of this shareholder apathy has meant that managers can potentially pursue their own objects.

This is, however, a necessary function for management as Ezzamel and Watson point out 'executives are primarily employed to use their skills, experience and judgement on behalf of shareholders' and in order to do so they need a 'significant element of discretion and relative freedom of action' but they do also note that without being called to account 'such freedom can be, and often is, abused'[3].

Berle and Means believed that not all managerial objectives would be self-serving. They believed that rather than furthering their own interests, or even those of the shareholders, the management might act in the interests of the whole society. This theory of 'corporate conscience' has inherent flaws as it fails to identify the means by

[1] in their study of American capitalism entitled 'The Modern Corporation and Private Property.'

[2] Olson, M, 'The Logic of Collective Action: Public Goods and the Theory of Groups,' 2nd Edition, 1971, Cambridge

[3] Ezzamel, Mahmoud & Watson, Robert 'Wearing Two Hats: The Conflicting Control and Management Roles of Non-executive Directors," in *Leadership*, Robert P Vecchio (Eds) University of Notre Dame Press, p.57.

which managers would be constrained to act in such a way and as Parkinson illustrates 'dispersal of shareholdings has led to effective control over the company being ceded to management'[4] and as managers don't own the company and receive a salary so are not dependant on high dividends, they can turn their concern to maximising their own utility rather than the profits of the company.

Also 'directors and managers have interests or aspirations which differ from those of the members, and hence their objectives are likely to diverge from the goal of maximising profits'[5]. Shareholders have purely financial interest where as managers may want to pursue an increase in company size and market share, managers are able to pursue such divergent goals and objectives 'not only because of lack of shareholder control but also because of weak competitive conditions'[6]. Such imperfect competition and the nature of markets tending to lean towards oligopoly allows such objective diversification as the market can no longer regulate the company as an economic unit and so there is the potential for unchecked corporate power, the threat of which only increases due to the shareholder apathy and inability to control the management.

Thus it can be seen that the separation of ownership and control creates problems and there is great belief that the absence of effective supervision of management is an important factor in the weak performance of the British economy[7].

The problem in large companies is that management have the potential to pursue deviant goals or shirk and weak shareholder control and accountability may lead to the survival of an incompetent board. To combat such problems the Cadbury Report placed an increasing emphasis on the role of institutional investors to monitor corporate governance and they state clearly that 'because of their collective stake, we look to institutions in particular, with the backing of the institutional shareholders

4 Parkinson, J.E., '*Corporate Power and Responsibility*' 1st Edition, 1993, Oxford University Press, p.56
5 *Ibid*, p.56
6 *Ibid*, p.56
7 *Ibid*, p.71

committee, to use their influence as owners to ensure that the companies in which they have invested comply with the code'[8].

The emphasis, placed on institutional investors to monitor the management of the company for the good of the individual shareholders and eliminate the separation of ownership and control, is due to their size and the belief that they have the ability and strength to influence the actions of the company.

This would appear to be a relatively straightforward proposition but as Charkam points out 'many institutions view shares as commodities with no intrinsic qualities other than that they can be readily tradable in an active market'[9]. Thus if institutional shareholders are to be active in their monitoring role they first need to consider themselves as owners of the companies they have invested in and not merely see the shares as a short term, profit making, investment. If the institutional investors don't take such a role then they can never be expected to monitor and control the activities of management.

The Cadbury Report believes that institutions can effectively conduct such a monitoring role if they consider their shareholdings as long term and are willing to incur additional expenses in correcting mismanagement. But why, when individual shareholders are unwilling to act and incur detriments, should the institutional investor do it for them? This point is reinforced by Drucker who believes that 'the pension funds are not 'owners', they are investors. They do not want control. The pension funds are trustees. It is their job to invest the beneficiaries' money in the most profitable investment. They have no business trying to 'manage''[10]. If they don't like how the company is being managed then they owe a duty to the beneficiaries to sell the shares and re-invest in order to profit maximise.

As with all shareholders, institutional investors face the 'free rider' problem and consequently it is difficult to see how an institutional investor can be relied upon to

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8 Gee, '*Report of the Committee on the Financial Aspects of Corporate Governance*,' 1992, London.

9 'Are shares just commodities?' J.P Charkam. 34-42.

10 Drucker, P.F., 'The Unseen Revolution: How Pension Fund Socialism Came to America,' 1976, London: Heinemann.

effectively monitor and control the activities of management when there are apparently very few incentives for them to become involved and bear a private cost for a public good.

The Cadbury Report counteracted this argument by illustrating that institutions should work collectively. This, as Davies point out, stems from the idea that institutional investors are 'locked in' to their shareholdings and so cannot use their power to exit without causing an adverse movement in the price of securities. Also 'in spite of the possibilities for overseas investment, the institutions are to some large degree locked into the UK economy and therefore have an interest in the efficient functioning of its major components'[11]. Davies argues that this puts emphasis on collective action, as intervention would be in their economic best interests and not simply that they have no option but to intervene.

This however doesn't stop the free rider problem as the benefits of collective action go to every institutional investor even if they have not borne any costs. Black and Coffee reinforce the fact that there is a lack of incentive to collectively act due to an 'absence of a generally accepted mechanism for cost-sharing amongst institutions'[12].

Whilst Hutton suggests that institutional investors have obligations as owners to exert control over management[13] and Davies believes that the institutions' economic well being will be furthered by more interventionist policies as well as the well being of other groups[14], Short and Keasey take the alternative viewpoint that it is not at all clear that institutions have incentives to devote resources to active monitoring[15].

It is this viewpoint, which seems to be the reality and the willingness and ability of institutional investors to intervene in the activities of management are limited by many factors. As Short and Keasey point out 'if they intervene publicly, they are

[11] Davies, P., 'Institutional Investors in the United Kingdom' in Prentice, D. and Holland, P. (eds), Contemporary Issues in Corporate Governance, 84.
[12] Black, B.S. & Coffee, J.C., 'Hail Britannia?: Institutional Investor Behaviour under Limited Regulation,' 92 *Michigan Law Review* 1997.
[13] W. Hutton. 'The State We're In,' Vintage, 1995.
[14] Supra, n.11 , p.84
[15] Short, H. & Keasey, K., 'Institutional Shareholders and Corporate Governance in the United Kingdom,' 1997, in *Corporate Governance: Economic and Financial Issues*, Oxford University Press, eds Kevin Keasey, Steve Thompson and Mike Wright, p.18

effectively drawing to public attention the difficulties the company is facing' this will have a knock on effect of lowering share price, thus lowering the value of the investment.'[16]

Another problem if the institutional investor becomes involved in the activities of management is that they will gain inside information and become unable to trade in those shares, causing further losses. The main problem for institutional investors is that due to the diverse portfolio they hold, they will be unable to effectively monitor the activities of management due to the cost in terms of time and money.

Even though institutional investors are in a better position to effectively monitor and control the activities of management than small individual shareholders, the institutional investors face conflicts of interest, which individual shareholders don't. Institutional investors and the board may find it beneficial to co-operate on certain issues and institutional investors may have current or potential business relationships with the firm, which will make them less wiling to actively curb management discretion for fear of jeopardizing those relationships.

These are obvious disincentives to intervene in governance issues but despite this there are examples where institutional investors do choose to voice their concerns such as Postel who found it beneficial to openly intervene, the benefits of which outweighed the detriments. When institutional investors are willing to intervene they are in an advantageous position in comparison to individual shareholders as they have many more actions available to them. They can refuse to partake in rights issues and may make the provision of finance subject to changes in governance. They can make adverse public comment, remove directors via general meeting and pose the threat of sale of shares and takeovers. It is due to the size and power of the investors that the biggest and most powerful weapon available in controlling management is the threat of potential action that can be taken.

This shows that when institutional investors do, or threaten to, act they hold power but whether they can be relied upon to control management is doubtful as there is no

[16] *Ibid*, p. 26

consistency and they have tendencies to veer towards short-termism. As Black and Coffee state 'for most institutions, activism is crisis driven'[17], and how can they be relied upon when monitoring which does take place is done privately so it is not known when it is occurring or what is being done to control management discretion.

The most important issue, which suggests that institutional investors cannot be relied upon to effectively monitor and control the activities of management is that the institutions suffer from the very same problem of separation of ownership and control that companies do and therefore the same potential uncurbed management activities. There are suggestions that institutional investors are less accountable to their owners than are corporate managers[18] and so they are not immune from corporate governance problems. This may lead to a situation where they are criticising the companies they invest in purely to draw attention away from their own problems.

In addition to institutional investors the Cadbury Report focused on the role of non-executive directors and viewed them as also having a major role in improving the accountability of executives to their shareholders. It focused on the composition of the unitary board and the monitoring role of the non-executive directors in relation to the executive board members. The report recognised that non-executive directors legally have exactly the same duties as other board members for the conduct of the business but emphasised their role as independent monitors of senior executives[19].

The proposals are restricted to what can be achieved without making any fundamental changes to the legal responsibilities of non-executives, the basic structure of the unitary board or the UK's accountability disclosure system[20]. The Code recommends that the board should include non-executive directors of sufficient calibre and number for their views to carry significant weight[21].

The Report recommends that every public company should employ a minimum of three non-executives but doesn't go on to resolve the problems regarding the

[17] *Supra*, n.12
[18] Coffee, J.C., 'Liquidity versus Control: The Institutional Investor as Corporate Monitor,' (1991) 91 *Columbia Law Review* 1278
[19] similar arguments have recently been put forward in the Greenbury Report in 1995.
[20] *Supra*, n.3, p.56
[21] The Cadbury Code of Practice, para 1.3

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conflicting roles expected of them. They do recognise they have a dual function because they state that 'the emphasis in this report on the control function of non-executive directors should not in any way detract from the primary and positive contribution which they are expected to make, as equal board members, to the leadership of the company'.

If the non-executives are truly independent of those they are supposed to be monitoring then they could be seen to be a reliable way to effectively control the activities of management, as they then possess the ability to assess the company's performance and that of the management from a neutral standpoint.

However 'despite the presence of non-executives, it is widely recognised that the boards of directors in UK companies are generally dominated by executives'[22] and a study indicated that 'typically executive directors outnumbered non-executive board members by two to one'[23]. This illustrates that the executives dominate in numbers but they also dominate because they control and have privileged access to internal information and without access to this information the non-executives cannot be expected to fully control management as they won't know what the underlying problems are or where directors are using too much discretion or aiming towards objectives which won't benefit shareholders.

On a more positive note 'if the non-executives on the board are independent of the executives, have reserved functions and powers, and/or are highly organized and motivated with access to sufficient resources seriously to monitor executives, then their influence may be much greater than their small numbers may suggest'[24]. The reliability of non-executives to act as efficient monitors may stem from 'an incentive to act in shareholders interests because of their high investment in establishing and maintaining their reputations as 'decision experts'.'[25]

22 *Supra*, n.3, p.62

23 Cosh, A. & Hughes, A., 'The anatomy of corporate control: directors, shareholders and executive remuneration of giant US and UK corporations,' (1987) 11(4) *Cambridge Journal of Economics* 285-313

24 *Supra*, n.3, p.63

25 Fama, E.F. & Jensen M.C., 'Separation of ownership and control.' (1983) 26 *Journal of Law and Economics* 301-326

Because of the separation of ownership and control and the lack of incentives for shareholder to monitor executives, the result is that non-executive directors are needed. There is an inherent problem with ensuring their independence as 'since it is the executives that actually do the hiring, an external labour market for non-executives is simply likely to lead to a high value being placed on non-executives with a reputation for 'not rocking the boat'.'[26]

Due to the fact that non-executives are part of the management and work closely with executives it cannot be expected that they can be independent monitors and also there is no way in which non-executives are held accountable to shareholders so this does nothing to enhance their independence or to instil confidence in their monitoring capabilities[27]. This is confirmed in a survey by PA Consulting and Sunbridge in 1991 which revealed that 70 percent of non-executives were personal aquaintances of the company's chairman.[28]

Davis and Kay identify the main problem as being that 'non-executives are in general picked by the executives, owe their salary to the executives, and commonly share social and other business connections with executives'[29] and if the non-executive is solely working for one company then they may derive a large percentage of their income from their position.

Consequently there is an obvious lack of independence and as under the Companies Act the non-executives do not have any special legal status or powers they cannot insist on explanations or impose remedies, the lack of independence also means that they are unlikely to be demanding or willing to take decisions which are contrary to the wishes of the executives. The only way to ensure independence would be for to consider more dramatic changes such as changing UK company law to restrict non-executives to monitoring functions or change from unitary boards to two tier structures.

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[26] Short, H., 'Non-executive directors, corporate governance and the Cadbury Report: a review of the issues and evidence,' (1996), p.123-131

[27] Main, B.G.M. & Johnston, J., 'Remuneration committees and corporate governance,' (1993), 23 *Accounting & Business Research* 351-362

[28] Cited in 'Setting pay at the top' focus report. D. Bell. 1994.

[29] Davis, E. & Kay, J., 'Corporate governance, takeovers and the role of the non-executive director,' (1990), *Business Strategy Review* 17-35

Victoria Jones
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Without such changes, non-executives cannot be relied upon to monitor management as currently they can be seen as just a formality as there are no sanctions that can be brought against them for not being independent. This lack of independence means that they may not be monitoring management and controlling any mismanagement and may simply be acting in line with executives to the detriment of shareholders.

Consequently there is currently no efficient way to monitor the activities of management, which need controlling due to the problems caused by separation of ownership and control, unless changes are made to company law, which ensure independence of non-executives and require that institutional investors have a duty to act for the benefit of individual shareholder. The easier option, in the long run, may be to address the problem of separation and control directly.