Are Institutional Investors Part of the Problem or Part of the Solution?

Key Descriptive and Prescriptive Questions About Shareholders' Role in U.S. Public Equity Markets

By Ben W. Heineman, Jr. and Stephen Davis

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PREFACE

Both the Millstein Center for Corporate Governance and Performance at the Yale School of Management and The Committee for Economic Development have had as a priority focus the essential governance principles of publicly held corporations. They have both asked fundamental questions about the optimal roles of business leaders, boards of directors, shareholders and other stakeholders in achieving long-term growth and innovation with sound risk management and high integrity.

But both the Center and CED have become deeply concerned about the growing role of institutional investors in our public equity markets, both as to how they serve the individuals who invest their money in these institutions, and in the relationship between the investors and investee companies. Even though institutional investors own more than seventy percent of the largest 1,000 companies in the United States, there is far less known about many of them than about the public companies in which they invest. There is great diversity in purpose, strategy, governance and incentives of institutional investors which range from pension funds to mutual funds to insurance companies to hedge funds to endowments of non-profit institutions.

This important essay is an outgrowth of the lack of basic information concerning the role of institutional investors in our public equity world.

In January 2011, the Center and CED, in conjunction with The Aspen Institute Business and Society Program, co-sponsored a research roundtable on institutional investors attended by academics, think-tank analysts, leading practitioners and former regulators. The purpose was to crystallize the need for research on these subjects. (See Appendix III for a list of attendees.)

The research roundtable focused on three major questions:

- Do institutional investors adequately advance the goals of the individuals who have invested in them?
- Do institutional investors contribute significantly to "undesirable short-termism" in their publicly held investee companies?
- Can institutional investors become more effective "stewards" of publicly held investee corporations?

This significant paper serves very important purposes:

1. It demonstrates that addressing these three generic questions is critical to individuals, equity markets, publicly held companies, the economy—and to the troubling (and conceptually difficult) issue of good v. bad short-termism in investor and investee behavior.

2. But, as the paper also demonstrates, there is, indeed, a lack of information and analysis on a host of important empirical and prescriptive issues that relate to these three critical questions.

3. The paper persuasively makes the case that we need to have as much understanding about investor entities as we do about investee companies.

4. It points the way analytically towards the variety of issues which need to be addressed in answering the three generic questions—without trying to bias the outcomes. It invites much greater attention to these critical questions from all across the intellectual and policy spectrum and urges think-tanks and academic institutions to develop comprehensive programs to address the profound implications of the changing world of institutional investors.

5. We believe that the paper is an important contribution to the public debate because rather than arguing for new regimes of public policy or private ordering without facts, it proceeds from the proper belief that factual and policy analysis are inextricably bound together.

In the end, the paper poses the essential question: are shareholders part of the problem with modern capitalism or part of the solution? The answer, invariably, will be complex and nuanced, without a simple, single conclusion. But, in so effectively laying out the need for an informational foundation, this essay takes a vital step towards finding answers, either through public policy or private ordering.

The Millstein Center for Corporate Governance and Performance and the Committee for Economic Development are pleased to publish this working paper. We thank Stephen Davis and Ben W. Heineman, Jr. for both their intellectual leadership on this topic and their authorship of this paper. We also thank the participants of the roundtable and the many reviewers who provided helpful comments during the drafting of this paper. Thanks are also due to CED's Corporate Governance Subcommittee, which helped to develop the topic in an early phase and later reviewed the paper at its conclusion. Responsibility for the content lies solely with the authors and does not necessarily reflect the views of the institutions with which they are affiliated or the views of individuals who participated in the roundtable and subsequent reviews.

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Over the last twenty years, institutional investors have owned an increasing share of public equity markets—more than 70 percent of the largest 1,000 companies in the United States in 2009, for example.[1] Over the past two years, in response to failures of some boards of directors and business leaders, shareholders, including institutional investors, have been given increased powers to participate in—or have disclosures about—discrete spheres of governance in publicly held corporations.[2] Moreover, during this same period, and in multiple jurisdictions, there have been increasing calls from both the public and private sectors for institutional investors to play a broad "stewardship" role by "engaging" with investee companies to "help achieve long-term sustainable value" and to help curb excessive risk taking seen as a factor in the financial crisis.[3]

But with these shifts in market and legal powers have come questions about institutional investors which are similar to those raised in the recent past about the corporations in which they invest. These questions relate to goals, strategies, governance, performance and accountability and, importantly, the separation of ownership and control (agency problems).[4] They boil down to a bedrock query: do investors have the capacity to perform the role now expected of them? Institutional investors in this paper include: pension funds, mutual funds, insurance companies, hedge funds and endowments of non-profit entities like universities and foundations.

Policymakers who championed the transfer of enhanced powers to investors went well beyond available knowledge in crafting such a response to the financial crisis. This is perhaps understandable in light of the severity of the 2008 market seizures and the political pressures that arose in their wake. But there is no mistaking that the approach represents, in effect, a big bet that investor institutions can and will exercise rights responsibly, and that such behavior will make markets more sustainable, less prone to error, and more in sync with the interests of capital providers.

Moves to further empower investors lend urgency to the need to deepen knowledge of investor behavior. Three leading US bodies—the Aspen Institute Business and Society Program, the Committee for Economic Development and The Millstein Center for Corporate Governance and Performance at the Yale School of Management—agreed to explore this issue, especially because the level of available research effort and prescriptive analysis lags behind the voluminous writing on publicly held corporations. The trio convened a research roundtable in January, 2011 with academics, think-tank analysts, leading practitioners and former regulators. The purpose was to identify salient areas for future research and analysis.

The research roundtable focused on three fundamental and potentially interrelated issues about the role of institutional investors, all of which require more empirical and normative analysis.

First, do such investors adequately advance the goals of the individuals who give institutions their money—whether those individuals are pension fund beneficiaries, mutual fund investors, insurance beneficiaries or hedge fund investors? The basic question is the classic "principal/agent" problem: do those who manage the trillions of dollars of other people's money advance the interests of the ultimate beneficiaries—who may be dispersed and disengaged—or their own interests? This question has special salience today because of the many different steps in the investment chain. Agents abound. For example, one common sequence is that an individual contributes money to a pension fund; the trustees and executives, after being advised by an investment consultant, then allocate those monies to both internal and external fund managers, or to managers of fund of funds who in turn distribute the monies to yet other asset managers.[5]

Second, do institutional investors contribute significantly to "undesirable short-termism" in their publicly held investee companies? A number of commentators have argued that institutional investors put pressure on boards of directors and business leaders for increases in short-term share price at the expense of balanced long-term investment, risk management and integrity because of investor strategy (beat composite indices, for instance), compensation (say, for performance during quarter or year) and other competitive factors (i.e. continually outperform peer investors, not just indices).[6] Such pressure from investment managers arguably helped cause financial institutions to assume high leverage in an overheated housing market to keep stock price rising in lock-step with other financial service companies.[7] Given these factors, commentators have said: "Unsurprisingly, investment managers focus on delivering short-term returns….pressuring investee companies to maximize their near-term profits."[8]

Third, can institutional investors become more effective "stewards" of publicly held investee corporations, and how does that "stewardship" role differ from the role of boards of directors to oversee the direction of companies? This issue arises in part from the criticism that institutional investors were passive in the face of problems which caused the credit crisis and the financial meltdown (as opposed to being an active cause of that meltdown through short-term pressures): "….a successful financial system requires the oversight of vigilant market participants… (w)hen pension funds, mutual funds, insurance funds and other major investors are silent, vigilance is absent….(s)uch passivity invites abuse."[9] This criticism of institutional investor passivity has arisen many times before the most recent crisis. But the stewardship aspiration also stems from a desire to articulate fully the roles and responsibilities of shareholders—embodied, in part, by recent policy initiatives such as the U.K. Stewardship Code and U.S. Dodd-Frank reforms. Such a stewardship role is different than simply selling a stock. As Roger Ferguson, President and CEO of TIAA-CREF, has said: "Better to engage management on governance and strategy issues before problems arise and shareholder value plummets."[10] But given the complexity of many corporate decisions—and difficulties directors themselves have in overseeing multi-factorial business trade-offs—what is realistic in terms of time, effort and contribution in the relationship both from the "stewards" and from boards/management?[11] Do the investor "stewards" relate to boards, to management, to both—and at what level of detail on what kind of decisions?

The answers to these three fundamental questions about institutional investors will, of course, vary with type of investor. Answers will also turn on the interplay between factual research results and analysis of important prescriptive concepts and questions which, when articulated properly, provide the foundation for normative judgments about what are "proper" public policies or "proper" private ordering arrangements to address defined institutional investor "problems."

The three issues also may be interrelated. For example, beneficial owners who contribute to pension funds may seek steady, long-term growth in their assets, not short-term, up-and-down volatility; fund managers may seek to exploit short-term volatility for their own benefit, even though it is inconsistent with the longer-term objectives of the beneficial owners; and such steady long-term growth may be consistent with a proper investor stewardship role with investee companies played by those who control other people's money (the money of the beneficial owners). Even if the objectives of beneficial owners are, in fact, short-term, as with investors in some hedge funds, then those objectives may cause undesirable short-termism in investee companies and may preclude a serious stewardship role because of short time horizons (or because trading strategies are largely indifferent to governance concerns).

This paper attempts to capture the insights, research ideas, policy options and implications of discussion at the Aspen-CED-Millstein roundtable and from other analyses and commentary on institutional investors. The intent is to provide a resource for dialogue—in academia, in think-tanks, among regulators and among practitioners—for those who believe in the vital importance of institutional investors to the functioning of the economy and to informed debate about shareholders' role in meeting the expectations of society.[12] Some of the questions about them are descriptive, others prescriptive. Part I provides summary background information; Part II discusses the state of empirical research and describes some salient information gaps; Part III describes some relevant prescriptive issues; and Part IV outlines possible next steps. We have chosen to focus primarily on institutional investors in the U.S. equity markets because that subject is quite complex by itself, although we recognize that institutional investors who influence the U.S. markets are often active in global equity markets, too, and although we recognize (and will, at times, refer to) important policy or private ordering efforts aimed at institutional investors which are occurring outside the U.S. markets.[13] Also, in focusing on institutional investors, we do not mean to suggest that analogous governance problems of publicly held corporations—including long-standing issues of separation of ownership and control—are resolved. Our focus in this paper is simply on the problems at the "shareholder" end of the relationship.

BACKGROUND

1) Types of Institutional Investors

Although policy advocates and analysts sometimes discuss investors without differentiating among them, shareholders obviously come in many shapes and sizes. They are not one animal, they are a menagerie. Beyond the roughly 21 million individual investors—with their different objectives and strategies—in U.S. equity markets,[14] there are at a minimum the following types of institutional investors for which some data are available (see Table 1).[15] As noted below, gaps in the availability and quality of data for the full set of institutional investors—including endowments, hedge funds, sovereign wealth funds, private equity funds, and others—is an issue to be addressed.

Table 1. U.S. Equity Assets Held by Institutional Investors, 2009

Type of Investor	Assets Held	
	U.S Equities (US$ Trillions)	**Percent of Total Equity Market**
Pension Funds	4.2	20.7
-Private	*2.7*	*13.1*
-State and Local	*1.5*	*7.5*
Mutual Funds	4.2	20.9
Insurance Companies	1.5	7.3
Foundations	0.3	1.6
TOTAL	**10.2**	**50.6**

Source: The Conference Board, *The 2010 Institutional Investor Report: Trends in Asset Allocation and Portfolio Composition* (New York, 2010).

These data do not include hedge funds which manage tens of billions of dollars of other peoples' money and should be considered "institutional investors" for purposes of this paper. And these data do not show which funds manage funds internally, and which use a variety of external managers.

Of course, even within these broad categories there is great diversity. At the end of 2009, there were more than 700,000 pension funds[16], 8,600 mutual funds[17], 7,900 insurance companies[18], 6,800 hedge funds and 2,200 funds of funds[19] in the US alone. Pools that large manifest a wide spectrum of practices. And many of these institutional investors also hold foreign equity securities. Comprehensive data are not available. But, as an example, the 25 US pension funds with the largest holdings in foreign markets in 2009 had a total of US$215 billion in foreign equities, which accounted for 12.5 percent of their total cumulative assets.[20]

2) Institutional Investor Ownership Concentration

Since 1987, institutional investors have owned ever greater shares of the top 1000 U.S. corporations (measured by market capitalization). (See Table 2.)

Table 2. Institutional Investors' Share of Top U.S. Corporations, 1987 and 2009 (in percent)

	1987	2009
Top 50:	48.7	63.7
Top 250:	52.8	69.3
Top 500:	51.8	72.8
Top 1000:	46.6	73.0

Source: Source: The Conference Board, *The 2010 Institutional Investor Report: Trends in Asset Allocation and Portfolio Composition* (New York, 2010).

In 2007, the year before the financial crisis, institutional investors owned even greater shares in three of the four categories listed above: Top 250 (71.8%); Top 500 (75.3%); and Top 1000 (76.4%).

3) Decrease in Institutional Investor Holding Period

As the equity holdings of institutional investors and the concentration of institutional investor ownership have increased, the average period during which such investors hold equity securities has sharply decreased. For the New York Stock Exchange, the period was about 7 years in the 1970s and is about 7-9 months today.[21] Put a slightly different way, the volume on the New York Stock Exchange went from 962 *million* shares in 1962 to 265 *billion* shares in 2000 to 738 *billion* in 2009.[22] Some observers estimate that 70 percent of all U.S. equities trading is by "hyper-speed" traders who may only own shares for a few seconds.[23] Holding period, or turnover, data for other exchanges are not available, although they are likely to show a similar pattern.

A critical figure is the turnover rate of equity portfolios by different types of institutional investors as opposed to the shortened holding period on stock exchanges. But scant data exist on the holding periods of institutional funds themselves. Although some statistics are reported by the mutual fund industry on average holding periods, such data are generally provided as a weighted average, which lowers reported turnover relative to a simple average calculation. Based on weighted average, the holding rate in equity-based mutual funds was 3+ years in 1975; 1.3 years in 1985; and 1.5 years in 2009. A simple average calculation indicates a holding period of 1.25 years in 1985 and 10.6 months in 2009.[24]

II. EMPIRICAL RESEARCH: CURRENT STATUS AND AREAS FOR FUTURE WORK.

Each of the three fundamental issues about the role of institutional investors which were raised in the Aspen-CED-Millstein roundtable has been the subject of research both in academia and elsewhere. However, barriers such as limitations in data have been significant. What follows is a summary literature search for each of the three questions.

QUESTION 1: Do institutional investors adequately advance the goals of the individuals who give the institutions their money?

Research into the question of alignment of interests between beneficiaries (providers of capital) and investing agents has expanded as attention has shifted to the growing implication of institutional investment behavior in respect of corporate performance and the health of retirement savings. Studies have particularly addressed pension plans and mutual funds and especially their governance, a key factor relating to alignment with beneficiaries. But the possibilities of developing further empirical-based insights are constrained by the limited disclosure requirements applied to funds. Governance disclosure requirements in the US are far more robust in respect of public corporations, for instance, than of institutional investors of any type, either under federal or state statutes. The attached chart developed for this paper by Ann Morrow Johnson at the Yale School of Management illustrates the differences and makes an initial comparison with Australia, a market known for more extensive investor disclosure requirements.

TABLE 3: FUND DISCLOSURE

	Items Disclosed by US Corporations	Items Disclosed by Mutual Funds (according to SEC)	Items Disclosed by Trade/ Union Funds (according to Taft Hartley)	Items Disclosed by ERISA Funds	Items Disclosed by Hedge Funds	Items Disclosed by Australian Industry Funds
Is Stated Investing Strategy (Value of Long Term, Short Term, mixed, etc.) disclosed?	N/A	YES	YES	YES	NO	YES
Is Actual Method of Investing Disclosed?	N/A	NO	NO	YES	NO	YES
Is Method of Manager Compensation Disclosed?	YES	NO	NO	NO	NO	YES
Is There a Board of Directors?	YES	YES	YES	Not Required*	Not Disclosed	YES
Is the Frequency of Board Meetings Disclosed? If so, How Frequently?	YES, Varies	YES, At least quarterly	Yes, At least Quarterly	N/A	NO	Yes, regularly, but no set number
Is the Number of Trustees Disclosed? If so, How Many are There?	YES, Varies	YES, Varies	YES, Typically 4 from management, 4 from labor	N/A	NO	YES, Typically 10-15 trustees
Is attendance disclosed?	YES	YES	YES	N/A	NO	Not required, but encouraged; when a director attends fewer than 75% of meetings for 2 years is encouraged not to be re-nominated

Are Terms of Reference Disclosed? If so, What Are Those Terms of Reference?	YES, Members are given reports	YES, Members are given CCO reports	YES, Members are given reports	N/A	NO	YES, Members are given reports
Are there any skill requirements disclosed? If so, what are they?	YES, Trustees must have some accounting knowledge	NO	NO	N/A	NO	YES, Trustees must be registered and licensed
Is there any disclosed accountability? If so, what does it entail?	YES, Trustees must act in best interest of shareholders	YES, Trustees must act in best interest of individual investors	YES, Trustees have "fiduciary responsibilities for the assets of the fund"	YES, Employers have fiduciary responsibility to participants and plan	NO	YES, Trustees must act in best interest of members and beneficiaries
Is the board makeup disclosed? If so, is the board comprised of insiders or independents?	YES, both	YES, majority independent (90% of boards are 75% independent as of 2009)	YES, Representative of management and labor (but not necessarily independent)	N/A	NO	YES, Mixed Representation- Equal number of trustees representing employer, employee, and independents
Is board leadership disclosed? If so, how is board leadership structured?	YES, Chairman of board- often CEO	YES, varies greatly	YES, Board Managers	N/A	NO	YES, Independent chair of Trustee board

* Note: Although ERISA funds are not required to have a board, participants of ERISA funds must be provided plan summaries, and employers must report information about the plan to the Labor Department and participants upon request.

Sources and Acknowledgements: Securities and Exchange Commission Website; Australian Council of Superannuation Investors; Governance Metrics International; Council of Institutional Investors; Australian Prudential Regulatory Authority; Mutual Fund Director's Forum; United States Department of Labor, ERISA website; Department of Labor, Bureau of Labor Statistics

Despite data limitations, important empirical studies on this topic include the following.

- A handful of papers focus on the relationship between the governance characteristics of a fund (e.g. independent board v. single fiduciary) and returns. Dewenter, Han and Malatesta (2009)[25] provide some, generally weak, evidence that the better governed a sovereign wealth fund, the better the performance of its portfolio companies. Ambachtsheer, Capelle and Lum (2008) [26] "found a positive correlation between fund governance quality and fund performance," echoing results first identified in 1997. Using proxies for fund governance quality, authors concluded that data imply the top governed funds "outperformed the bottom ones by an average 2.4% per annum (i.e., 3 x 0.8) over the 2000-2003 period."

- Ambachtsheer (2011)[27] provides a case study of the Canada Pension Plan to review the relevance of internal pension fund compensation practices and fund performance over time. The CPP is one of few pension funds that have explicitly attempted to design metrics linking internal pay to long-term performance.

- Stewart and Yermo (2008) [28] undertook a comparative survey of pension fund governance arrangements among OECD member states and highlighted features that they identified as associated with poorer performance. These included poor representation of stakeholders, substandard training for trustees and insufficient controls for conflicts of interest.

- Cohen (2007)[29] found that mutual fund family trustees significantly overweight the stocks of companies for which the family serves as agent in 401(k) plans, even when other funds are selling the stock. "We quantify a potentially large benefit to the 401(k) sponsor firm of having its price propped up by its trustee fund's more severe overweighting," they conclude. "We also estimate the resulting loss to mutual fund investors. In some cases, this can be large." The analysis is considered important evidence of conflicts of interest working to skew mutual fund behavior toward commercial interests to the detriment of beneficiaries. The US SEC took the view that such conflicts may have contributed to scandals such as those involved in market timing, and it issued new rules requiring 75 percent independent fund boards as well as an independent chair. The regulation on board leadership was reversed in a court challenge. But at least one study questioned the SEC assumption that mutual fund board independence benefits beneficiaries. Ferris and Yan (2006)[30] data showed that "neither the probability of a fund scandal nor overall fund performance is related to either chair or board independence."

- Taub (2008)[31] found a "statistically meaningful negative correlation between defined contribution (DC) assets and support for shareholder resolutions." Taub's data demonstrated "that the greater the dependency of the Adviser upon the DC channel for asset management business, the less likely the fund family will be to support shareholder-sponsored governance resolutions."

- Cremers, Driessen, Maenhout and Weilbaum (2009)[32] tested whether fund performance correlated with ownership of stakes by mutual fund directors. They found that "funds in which directors have low ownership, or 'skin in the game,' significantly underperform" relative to peer companies with boards featuring high director ownership of shares.

QUESTION 2: Do institutional investors contribute significantly to "undesirable short-termism" in their publicly held investee companies?

The prevailing view in the marketplace is that short-term perspectives by both investors and corporate boards are generally associated with negative outcomes, while long-term perspectives are considered to contribute to positive outcomes. Even among practitioners such broad generalizations leave open big questions, such as negative or positive for whom, and over what time horizons. In the academic sphere, data and analysis that might provide insights into this assumption come to mixed conclusions. But more importantly, the number of credible and persuasive studies addressing the topic is relatively low, especially considering its importance, owing to a variety of structural barriers.[33] Among them are:

- **Categorization**. Few investing institutions may easily be classified as either long or short term. More typically, depending on the requirements of ultimate beneficiaries (and the extent to which these requirements are reflected in asset allocations or stewardship practices), an investing body may feature a complex mix of short and long-term instruments and policies. This tendency represents a challenge to researchers seeking to disaggregate data to associate investments with outcomes.

- **Scarcity of data**. Institutional investors are required to reveal only limited information on key variables that affect timeline studies such as asset holdings, ownership behavior, investment tactics, portfolio manager compensation and fund governance characteristics. How much disclosure is available hinges on the market, the quality and vigor of regulators, whether the institution is privately or publicly held or state controlled, and the types of investor. Absent regulatory mandates, only select institutions are prepared to reveal data on a voluntary basis. Reluctance stems at least partly on grounds that such information constitutes the proprietary 'secret sauce' that gives advantage over competitors. Further, information that is revealed on a voluntary basis to researchers is subject to question on accuracy as sources may have reason to be selective in what they unveil and there are few means to audit figures for assurance.

- **Relevant time-frame.** The universe of "long-term institutional" investors is not only relatively uncertain but it is a challenge for scholars to define and then obtain sufficient data over meaningful timeframes.

Notwithstanding hurdles to research, a number of important studies have emerged in recent years that tease out findings on short term/long term from scarce data. Here is a sampler:

- Gaspar, Massa and Matos (2004) demonstrate that investors who behave short term are more frequently associated with mergers and acquisitions that "allow managers to proceed with value-reducing acquisitions or to bargain for personal benefits (e.g. job security, empire building) at the expense of shareholder return." In fact, corporations heavyweight with short-term investors are "more likely to receive an acquisition bid but get lower premiums." Authors contend that this is because managers are "weakly monitored" by funds with short time horizons. Bidder companies' behavior is also affected by the timeframes of their owners. "Acquirers with short-term shareholders prior to the merger are found to underperform significantly (by as much as -0.7% monthly, or -8% per year, over a holding period of three years), compared with acquirers with long-term shareholders."[34]

- A 2011 report by the World Economic Forum, directed by Josh Lerner of the Harvard Business School, identified a series of constraints that limit capital available for long-term investing by pension funds, endowments/foundations, life insurers, sovereign wealth funds and family offices (but not typical defined contribution savings vehicles such as mutual funds). These include (1) "the need for principals, trustees and managers to believe strongly in a long-term investment strategy"; (2) "the goals and objective of the investment decision-maker might not be aligned with those of the beneficiaries of the investment fund" owing in part to skewed compensation schemes, risk measures that penalize managers who favor long-term investments, and career considerations; (3) behavioral biases in favor of short-term decisions may be strong; (4) "the long- term investor might be resource-light—in terms of professionals and budget—relative to other investors"; (5) length and complexity of the investment decision chain linking the ultimate beneficiary with asset allocation.[35]

- Haldane and Davies (2011)[36] , in a paper published by the Bank of England, attempt to demonstrate that the definition of what is long term in investor outlooks has shortened considerably over time. "Short-termism is both statistically and economically significant in capital markets. It appears also to be rising. In the UK and US, cash-flows 5 years ahead are discounted at rates more appropriate 8 or more years hence; 10 year ahead cash-flows are valued as if 16 or more years ahead; and cash-flows more than 30 years ahead are scarcely valued at all. The long is short. Investment choice, like other life choices, is being re-tuned to a shorter wave-length." The authors go on to hypothesize implications of such data: "This is a market failure. It would tend to result in investment being too low and in long-duration projects suffering disproportionately. This might include projects with high build or sunk costs, including infrastructure and high-tech investments. These projects are often felt to yield the highest long-term (private and social) returns and hence offer the biggest boost to future growth."

- Studies focusing on the impact of long-term investment by sovereign wealth funds (SWFs) on share price returns arrive at different results. Papers by Raymond (2008)[37] and Kotter and Lel (2009)[38] each find significant short-term price jumps of up to 6 percent at target firms when a sovereign wealth fund invests. The market, it would appear, rewards such stocks out of a belief that SWFs can play an important role as owners to encourage performance. However, a number of studies also show that such effects are not long lasting. Bortolotti, Fotak, Megginson and Miracky (2009)[39] hypothesize that this may because such funds shy away from assertive monitoring for fear of political resistance. So the expectation that SWFs are responsible stewards may be inflated.

- Funds identified as short term in investment outlook appear to be associated with corporations downsizing research and development budgets to meet earnings objectives. So concluded Bushee (1998).[40] A fresh analysis by Derrien, Kecskes and Thesmar (2011)[41] appears to substantiate such findings.

QUESTION 3: Can institutional investors become more effective stewards of publicly held investee corporations and how does that stewardship role differ from the role of boards of directors to oversee the direction of companies?

Unlike the other two questions, this addresses the engagement capacity of institutional investors with investee companies and involves inquiry into normative practices (see Part IV below) more than empirical tests. Among leading documents along these lines are the following.

- FairPensions published a study[42] in March 2011 contending that confusion, outdated assumptions and suboptimal governance practices have distorted interpretation and implementation of fiduciary duty practices among institutional investors. Such consequences have caused value losses to beneficiaries and harmful short-term behavior among portfolio companies, in the view of the report's authors. Modernization of notions of fiduciary duty is required, they assert, for institutional investors to become effective stewards of investee companies. Others have recently tackled the question of fiduciary duty within the investment chain. Waitzer (2009)[43] asserts that a "duty of impartiality…directs trustees…to make diligent and good-faith efforts to identify, respect, and balance the various beneficial interests when carrying out the trustees' fiduciary responsibilities in managing, protecting, and distributing the trust estate, and in other administrative functions." That definition, Waitzer contends, supports the notion that trustees can guide investment judgments toward the long term, including taking into account risks beyond those purely and narrowly financial.

Johnson and de Graaf (2009)[44] make a parallel case for expanded definitions of duty for pension fund fiduciaries. An earlier, influential study by the law firm Freshfields Bruckhaus Deringer (2005)[45] compared fiduciary duties in investing institutions across multiple jurisdictions, and argued for modernized interpretations.

- Wong (2010)[46] addresses not the legal responsibilities of funds but their practical ability to enter into engagement. He makes a case that despite calls on institutional investors to step up dialogue with portfolio companies, "modern investment management practices and characteristics—such as financial arrangements that promote trading, excessive portfolio diversification, lengthening share ownership chain, misguided interpretation of fiduciary duty, and flawed business model and governance approach of passive funds—make genuine stewardship challenging for institutional investors." Wong's analysis echoes observations about investor engagement capacity in speeches made by former Gartmore chief and UK City Minister Lord Myners. Similar concerns are raised in serial consultations issued by the UK's Department of Business, Industry and Skills (BIS). For instance, the Department's paper "A Long Term Focus for Corporate Britain," released in October 2010, sought market guidance on impediments to investor engagement with listed companies. It has so far resulted in a summary of responses published by BIS in March 2011.[47] The European Commission's April 2011 Green Paper on corporate governance[48] similarly asked for market advice on how to overcome obstacles to shareowner engagement.

- A February 2009 roundtable of practitioners convened by the Millstein Center in New York found consensus in diagnosing eight flaws responsible for institutional investors failing to exercise sufficient vigilance as owners.[49] Among factors raised by participants:

  - Short-term thinking finds expression in the way many institutions structure compensation arrangements for portfolio managers, with incentives based on time periods that encourage trading, rather than stewardship;

  - Many institutions lack transparency around their own governance, policies and operations;

  - Oversight bodies at institutions are typically not optimally composed, with common shortfalls in skills, leadership and clout;

  - Within funds there are silos of fund managers and governance staff who may not communicate or interact with each other when developing portfolio company analyses or communicating with such companies;

  - Fund investments are usually highly fragmented, with fractional holdings across thousands of stocks, making it less advantageous for any one fund to perform careful monitoring, sponsor sustained engagement or mount needed intervention at companies harboring material environmental, social and governance risks; and

- Funds allocate limited and often insufficient resources to engagement.

4) Research Gaps

As noted later in this paper, the prime research objective should be to create a generally accessible database of governance and pay characteristics that could serve as a resource for analysis of investor, corporate and capital market behavior. But there are a multitude of specific research projects that could be undertaken to expand knowledge on the interplay of time horizons, fund governance and capital market behavior. A selection of these, drawn from papers as well as the Aspen, CED and Millstein Center Roundtable in New York on January 19 2011, is as follows:

- Gaspar, Massa, Matos suggest further studies probing "the outcome of other events in which shareholder monitoring and bargaining constitute major features (such as proxy fights, going private transactions, or self-tender offers)."
- Gaspar et al also challenge researchers to identify "key attributes that attract long-term capital to a company or that persuade existing shareholders to hold their investments for longer periods."
- How might incentives arising from delegated asset management (for instance, the structure and characteristics of compensation arrangements for portfolio managers) affect investment time horizons and stewardship behavior?
- Might there be a relationship between, on the one hand, different models or aspects of fund governance and, on the other, investment horizons, asset allocation, risk tolerance, expectations of returns, real returns (over different time periods), stewardship resources and behavior, and engagement with portfolio company boards?
- Might there be a relationship between, on the one hand, different levels of complexity in the investment decision chain and, on the other, investment horizons, asset allocation, risk tolerance, expectations of returns, real returns (over different time periods), stewardship resources and behavior, and engagement with portfolio company boards?

III. PRESCRIPTIVE ISSUES: PUBLIC POLICY AND PRIVATE ORDERING

Institutional investors raise fundamental issues about the functioning of our capital markets, about the protection of individuals, about the potential for economic harm due to market strategies and about the relationship between investors and investee companies. Here, in broad outline, are some of the prescriptive questions which either public policy or private ordering might address—especially after development of additional anecdotal or systematic empirical data.

1) Greater Disclosure and Transparency

This paper has noted some important empirical questions about how different types of institutional investors function. But, as discussed above, there are significant data gaps which obscure knowledge of these vital market bodies. Among them:

- types of goals;
- governance structures, including tactics to promote alignment with beneficiaries and ultimate investors;
- strategies to carry out goals;
- the number of companies followed by internal fund managers;
- compensation arrangements for both inside and outside fund managers;
- impact on markets; and
- questions of how institutional investors currently address issues of responsibility and accountability.

In the US, the main types of institutional investors—pension funds, mutual funds, charitable foundation/educational institutions, hedge funds, sovereign wealth funds, private equity funds—all operate under different federal and state laws.[50] With respect to policies directed at increasing disclosure and transparency and developing—or creating the opportunity to develop—systematic data collection, some of the important questions are:

- What are current disclosure requirements for each type of institutional investor under what law or laws?
- Should there be additional requirements—either through regulation or through voluntary private sector organizations or associations—for different types of investors, on a regular, systematic basis, to disclose more data about how they function, including risk management regimes?
- Should either the regulator or the voluntary association aggregate and publish that data on a periodic basis?

Thus, one key aspect of future analysis, discussion and debate about different types of institutional investors is whether new policies should be put in place—through regulation or private actions—to increase transparency and disclosure.[51]

2) Addressing a Possible Mismatch between Goals of Individual Investors and Actions of Institutions Which Invest Their Money

a) Defining the Problem. Identifying any "mismatch" between the goals of the individual investor and the institutions which manage their money—between the principal and the agent—requires information about objectives, policies, practices and impacts and a normative position from which to determine whether such a "mismatch" exists. A pensioner with long term saving and steady growth objectives but whose monies are siphoned off through a long investment chain which is more focused on short-term rewards for intermediaries, such as consultants and fund managers, may be one issue. Poor performance in a mutual fund may be another. "Sophisticated" investors who object to the exorbitant management fees (the two percent management fee in "2 and 20" arrangements) that they pay to hedge funds which lose value is yet another. So is the general issue of fees imposed on individuals by funds which in some sense "underperform."[52] So, too, institutional investors may fail to assess issues of risk, integrity and sustainability which can have a significant impact on returns for individual investors. (See p 26.)[53]

A key threshold challenge is differentiating between types of individual investors in institutional funds and determining which ones should be able to protect themselves against agency problems created by fund executives and fund managers (both internal and external) and which ones may require additional protections because of such problems. Should mismatches between an individual's goals and institutional performance just be remedied by market forces? Or are such mismatches a question of concern which may require a new public policy or private ordering response? This is a foundational descriptive-prescriptive question about the relationship between the individuals who contribute capital and the institutions which invest it.

b) Enhanced Regulation. One important issue is the effectiveness and possible enhancement of regulation of institutional investors to protect individual contributors. For example, the US Department of Labor's protection of retirement savings under the federal Employee Retirement Income Security Act of 1974 ("ERISA") has been the subject of much scrutiny and criticism about its mission, its effectiveness in implementation and about the need for enhanced regulatory attention.[54] Other regulatory regimes (e.g., SEC oversight of mutual funds, or state-level oversight of public employee retirement plans) could be subjected to a similar analysis.

c) Analogy to Publicly Held Companies. Many governance and disclosure rules—for example in federal and state law and in stock exchange listing requirements—have the purpose of protecting shareholders in publicly held companies.

But this rationale may require review in light of the historic shift over the past quarter century of individuals giving their money to institutions to invest rather than investing directly in listed companies (a trend often characterized by the word "deretailization"). An important question now arises about the degree to which those institutional investors should be analogized to public companies and about the degree to which public company governance and disclosure rules should be applied to those institutional investors in order to protect individuals. This issue is a variant of questions, noted immediately above, about enhanced regulation.

d) Fiduciary Duties. For pension funds and mutual funds, significant questions have been raised about the effectiveness and appropriateness of current concepts of trustees’ fiduciary duties.[55] The duty of prudence, it is argued, has led to a “lemming standard” where trustees are judged by actions of other trustees—and much imitated investment approaches and performance benchmarks have led to short-term strategies with deleterious effects. Similarly, the duty of loyalty, it is argued, has been diluted by the complexities of modern-day investing, by the use of consultants and extended investment chains, and by principal-agency problems reflected in inadequate management of conflict-of-interest policies relating, for example, to pension governing boards and to service providers. At the same time, critics argue, the independent duty of impartiality—which has reference not to industry practice but to optimizing protection of different beneficiary classes—has been eclipsed.

Another set of prescriptive issues thus relates to this critique of fiduciary duties and a possible re-redefinition of the duties of prudence, loyalty and impartiality. But through what means and in what forums? For instance, Wilcox (2011)[56] contends that an implied ‘duty to inform’ may be found within and derived from sections of the Model Business Corporation Act which outline the duties of corporate directors. His hypothesis is that expanded dialogue between boards and investing institutions could better align interests and contribute to “corporate stability.” He suggests that fund trustees may have a similar duty to inform. Does this set of issues differ for public and private pension funds?

e) Best Governance Practices. Another major area for normative analysis is to define “best governance practices” for institutional investors (beyond the possible regulatory analogies to publicly held corporations discussed above).[57] What does research show about:

- effective governance structures, especially the proper role of trustees/senior management, including their level of sophistication, their ability to manage outside fund managers and their decision-making processes?
- the effectiveness of stewardship codes in other jurisdictions on investor behavior and performance?
- the different implications of having investment management in-house and use of outside financial managers (which increase agency issues)—and the feasibility of in-house management for any but the largest institutional investors?
- setting performance objectives consistent with individual investor‘s’ goals?
- connecting pay with that performance?
- management of conflicts of interest?
- communicating with individual investors?
- effectiveness of risk management systems and processes?
- promotion of integrity and sustainability?

Institutional investor groups may have statements of general principles regarding their own governance and behavior but these may lack edge and specificity. More "operational" concepts could emerge from empirical research which is then utilized for prescriptive standards or recommendations by corporate sponsors or investor trade organizations.[58] For example, ideas include:

- increased use and disclosure of compensation, incentives, engagement, trading, and other matters that would support long-term performance and be in better alignment with the goals of ultimate beneficiaries;
- requiring more disclosure of governance characteristics of funds;
- mandating skill and qualification criteria for fund fiduciaries such as trustees, including continuing education; and
- ensuring that fund governance bodies exist, and that they include representation of both sponsor and beneficiaries and feature members capable of exercising independent judgment.

3) Addressing a Possible Mismatch Between Short-Term Interests of Institutional Investors and Long-Term Strategies of Investee Companies

a) Defining the Problem. As noted, a common critique of institutional investors is that they put pressure on portfolio company boards of directors and business leaders to take commercially risky or otherwise imprudent actions (e.g. assume undue legal or environmental risk) in order to achieve short-term share price increases. This can occur because of institutional investor compensation being linked to out-performing peer competition or out-performing indices within short time frames.

Yet, defining the actual problem with specificity is both empirically and conceptually difficult. What is "good" short-term behavior and what is "bad" short-term behavior? What is "good" investee company concern about creating long-term sustainable value and what is "bad" investee complacency and unwillingness to adapt to changing realities? These questions go to the heart of the purpose of the corporation, the appropriate goals of investors and the very nature of our public markets ("expectations market" v. "real market" or "efficient market theory" v. "behavioral theory").[59] Surely in our market economy investors are entitled to short stocks which they believe have less intrinsic value than their market price. Yet, can "shorts" destroy a valid long-term investee strategy? (What, for example, would have happened in the stock market to a major financial service company in 2006 or 2007 which gave up profits by spreading risk away from housing, reducing leverage and increasing liquidity?). Surely, some institutional investors pressure companies for short-term returns. Surely, some companies wish to make investments or conduct research and development which may affect quarterly stock earnings and risk a stock price drop. Most problematic, how great a divergence is there—over what period of time—between the "expectations" value put on a company by the market and the "intrinsic value" as evaluated by other financial and non-financial metrics set by the company and/or long-term value investors—and why does such a divergence exist?

Sorting out, from a normative perspective, what is "good" and "bad" short-termism—and "good" or "complacent" long-termism—is thus a critical analytic task in assessing the role of institutional investors and determining whether a) that is just the price we pay for a market economy; b) whether any public policy should apply to institutional investors to moderate "bad" short-termism; or c) whether private ordering by single institutional investors or at an industry association level is needed to constrain "bad" short-termism by institutional investors and their internal or external fund managers. What exists today? What is effective? What are possible changes, and how might they be implemented?

Once again, this larger question will vary, of course, with type of individual investor and the institution to which they give their money for investment. It also needs to be assessed in terms of how much freedom should be accorded different individual and institutional investor types. For example, some distinguish between *value* investors who are long-term holders based on evaluation of fundamentals; *growth* investors who follow short to medium trends; and *momentum* investors who trade short-term on events or mathematical models. A similar broad typology is: *intrinsic* investors looking at long-term value; *mechanical* investors basing trades on computer models rather than qualitative assessments of companies; and *trader* investors who bet on short-term stock movements. Are these distinctions capable of precise definition? If so, what percentage of the stock market do they affect over what time period; and what are public policy or private ordering implications?

b) Procedural and Substantive Issues. As noted above, a host of prescriptive issues relating to actions of institutional shareholders may arise depending on how one defines "bad" short-termism. Clearly additional disclosure and other procedural requirements imposed by regulations or advocated by relevant business associations or individual firms constitute one approach. Alternatively, substantive limitations may be appropriate subjects for analysis and then for public policy or private ordering recommendations. For example, as noted, one may advocate an enhanced duty of impartiality for pension fund trustees to better balance the interests of different beneficiary classes. Or one may urge a restructuring of fund manager compensation to provide greater incentive for support of long-term investee company strategies. Or, further, one might argue that fund managers should oversee fewer investee companies in order to understand better intrinsic long-term value.

c) "Short-Termism" at Investee Companies. A closely related issue is identification of policies and practices which would directly affect investee companies and indirectly affect institutional investors. These include both public policy changes directed at publicly held companies (e.g. tax code changes) and governance changes (e.g. revised corporate practices on "short-term" guidance or on more weight for longer-term shareholders in corporate voting). Attention is also focused on the fiduciary duties of corporate directors. For instance, Millstein (2011)[60] argues, in a review of theory and precedent on corporate board duties, that "director fiduciary duties should be understood to include the duty of impartiality, whereby directors act in the best interests of all their shareholders, of the corporation if you will; balancing shareholder conflicting interests can endorse long-term corporate sustainability." A useful starting list of policy issues relating to "bad" short-termism by investee companies, as well as by institutional investors, has been developed by the Aspen Institute Center for Business and Society Program in such areas as transparency, governance and taxation.[61]

4) Addressing a Possible Mismatch between the Ideals of Institutional Investor "Stewardship" and the Realities of Investee Governance

a) Defining the Problem. At the heart of the concept of institutional investor stewardship is that two-way engagement by corporate directors and senior management with shareholders will enhance alignment of the parties and improve the long-term performance of publicly held corporations. Formal changes in law (Dodd-Frank), establishment of quasi-regulatory regimes (the UK Stewardship Code) and the aspirations of major institutional shareholders (such as TIAA-CREF) represent a shift in emphasis—and perhaps in power—towards institutional shareholders in corporate governance.[62] But, given the great diversity in type of institutional shareholders, for which types—and which sub-types—does this "institutional investor stewardship ideal" make any sense? As discussed, many institutional investors have growth/momentum or mechanical/trading strategies which are not based on an analysis of the fundamentals of investee companies—and which boast stables of fund managers with oversight of multiple companies about which they cannot know business risks, opportunities, markets, competitors and management in detail. Do they have capacity or the will to act as stewards? The same question may be applied to fund managers who use a passive index approach (*momentum* or *mechanical* investors). Even funds with a more active approach may hold so many securities or have such limited staff that high intensity engagement is not possible across portfolios.

A critical related definitional question is what elements of investee performance concern those who wish to exercise an investor stewardship role. If investors are concerned with long-term commercial performance, what financial and non-financial metrics should they use to measure that performance? If investors evaluate financial performance taking into account risk management and promotion of performance with integrity and sustainability, what metrics should be used?[63] And, similarly, if they are concerned about integrating environmental, social and governance risks into investment management—with broader questions of sustainability and impact on society—what elements of corporate performance should be monitored?[64] Further, investors can influence investee companies by trading, by voting and by engagement. Do different approaches to stewardship involve different mixes of these essential "influencing" actions? And, as Simon Wong suggests, should a "stewardship" typology be developed—high intensity engagement, low intensity engagement, framework intervention—that will recognize the institutional investor diversity and make explicit the necessary variation in "stewardship" activities.

b) Evaluating Regulatory Reform on the Relationship Between Investee Companies and Institutional Investors. Provisions of Dodd-Frank, to be implemented by SEC rules, directly affect the institutional shareholder/investee company relationship. For example, Section 971 empowers the SEC to develop rules on proxy access; Section 971 requires "say-on-pay votes" for regular compensation and for special arrangements arising out of transactions and also requires certain institutional investors to report annually on how they cast votes on those issues; Section 957 requires national exchanges to prohibit member brokers from voting customer shares without instructions (following on a similar rule from the NYSE); Sections 952 (hedging by employees and directors), 953 (Executive Compensation) and 972 (board leadership) require further disclosures by all public companies. Section 956 requires certain financial institutions to disclose to regulators incentive-based compensation so that regulators can assess whether these arrangements could result in financial loss and can issue regulations to prohibit incentive-based compensation that encourages inappropriate risk. A systematic policy analysis over time of the implementation of these provisions—as well as prior regulation from Sarbanes-Oxley,[65] stock exchange listing requirements and other regulations—is important in determining such questions as impact, effectiveness, need for modification or need for additional regulatory provisions.

c) Evaluating Proxy Advisory Services. If, as suggested here, corporate governance is affected by the different behaviors of institutional investors, one of the hardy perennials for debate is the role of the proxy advisory firms. Many of the issues are well-known—do they exert too much influence? Do they measure issues which are important or unimportant to long-term company performance? Do they have conflicts of interest? Can there be more competition among such services? Are they too opaque? But this subject, too, should be framed within the context of a possible mismatch between "ideals" of stewardship and the relationship between investee governance and economic performance, risk management and integrity promotion.

d) Evaluating Stewardship Codes. Although this discussion paper is focused primarily on U.S. public policy and private ordering, it recognizes the importance of the U.K.'s implementation of a Stewardship Code adopted by the Financial Reporting Council (a quasi-regulatory entity which also oversees the UK Corporate Governance Code, formerly known as the Combined Code, affecting investee companies). In essence, the code requires institutional investors (including insurance, pension, trust and other funds) to explain how they will conduct their stewardship functions, including such issues as: how they will deal with conflicts of interest, monitor investee companies, escalate engagement with investee companies; when institutional investors should act in concert; and periodically report on stewardship. Per U.K. practice, institutional investors can abide by the code even if they opt out of recommendations so long as they explain why they do not/should not apply to them. Once again, a systematic analysis of the implementation and consequences of the code is highly relevant to research on the possible mismatch between stewardship ideals and corporate governance realities.

Such analysis needs to address issues including risks of obtaining improper insider information, acting illegally in concert and proper roles *vis a vis* boards of directors (see below). Although a stewardship code may not travel across the Atlantic in precisely the form pursued in the UK, an important set of questions is whether there are lessons from UK implementation of that code which are relevant in the U.S. context.

e) Evaluating Major Private Ordering Policies, Practices and Proposals for Advancing Stewardship Behavior Among Institutional Investors. In recent years, there has been an outpouring of ideas in shareholder proposals, institutional investor guidelines and academic writing on how investee companies should improve information and communications with shareholders. There has also been an increasing volume of writing about how institutional shareholders should change their policies and practices in order to discharge stewardship functions more effectively.[66] In light of systematic empirical research and emerging anecdotal evidence, prescriptive analysis and recommendations could be conducted on prioritizing the typology of proposals for action by institutional investors or relevant associations to better discharge a stewardship function. Areas for analysis include: job specifications for trustees and for a fund's CEO and Chief Investment Officer; enhanced accountability mechanisms (e.g. explicit approaches to stewardship and voting); and trends toward investor evaluation of broader definitions of commercial performance, risk management, integrity promotion and sustainability and the company's contribution to society.[67]

f) Relationship of Stewardship to Corporate Governance. Many advocates of increased stewardship have not analytically addressed two fundamental questions. First, how is the stewardship role different from the role of the board of directors? Second, does investor stewardship involve engagement with the board of directors or the CEO and business leadership or both—and on an approve/disapprove basis or on more detailed consultation, advice and involvement in specific business decisions or strategies.

The proper engagement of the board of directors with the CEO and senior management has been the subject of much governance writing in the past 15 years—and has proven to be difficult to define properly, much less to implement. It cannot be that major institutional investors have the same kind of intense role as the board of a corporation in defining the company's mission in the dimensions of performance, risk and integrity; in its articulation of key metrics for operations across the performance, risk and integrity dimensions; in its detailed compensation for top leaders and in its focused oversight consistent with mission and metrics. Many important corporate decisions involve complex trade-offs between different stakeholder interests across different time frames. So analytic questions arise: what is different between investor stewardship and board governance?[68] How can investors understand the demands of other stakeholders which are at the core of corporate decision-making for the long term? How much time is required for detailed dialogues and with whom—and what is sacrificed by a reallocation of corporate resources to "stewardship" activities?

One example of the debate may be found in the new US mandate for say-on-pay votes at public companies. Should investors enter into a kind of information arms race with management—gathering detailed independent metrics about the way a company pays top talent—or should funds simply assure themselves that savvy directors aligned with shareowners are in place to make decisions?

Another fundamental question is: given the nature of today's public markets—and the number of institutional shareholders who invariably are going to follow momentum or mechanical or short-term trading strategies—how, in reality, can those investors who take seriously their stewardship role help the board and the CEO choose a longer-term strategy, stick with it and not be concerned about the short term—but also how can those investors decide when the strategy needs recalibration? These are fundamental prescriptive questions which also require additional analysis.

IV. CONCLUSION

The increasingly important role of institutional investors in our economy and our public markets requires substantial new intellectual attention.

Our principle concern is that either public mandates or private efforts are needed to assemble a global database with fundamental empirical information about different types of institutional investors: in particular, their goals, time frames, strategies, governance structures, governance processes, incentives, compensation practices, transparency, holding periods and market impact—and their view of fiduciary duties, accountability and stewardship role. Such a database is a necessary prerequisite for efforts to advance understanding of the critical role institutions increasingly play in the functioning of capital markets around the world.

Second, we hope analysts from all across the intellectual spectrum will engage in the three fundamental prescriptive questions which animated the January 2011 Aspen-CED-Millstein roundtable and which provided the framework for this paper. Do institutional investors carry out the goals of their individual beneficiaries? Do institutional investors contribute to "improper" short-termism? How can institutional investors play a stewardship role in support of longer-term corporate strategies which effectively counters improper short-termism and which meshes appropriately with the responsibilities of boards of directors and senior leaders of investee companies?

But these intellectual challenges require institutional attention and support.

At a minimum, we plan to use this paper as a grounding for workshops convened by the Millstein Center, CED and the Aspen Institute Business and Society Program to stimulate development of an investor database along with further discussion and new work from academics, think-tankers, regulators and practitioners in both the investor and investee communities. Other institutions (for example, business schools and law schools) are invited to use this and other papers for similar purposes.

But beyond conferences to energize work on this critical set of issues, it would certainly be appropriate—and definitely in the public interest—for academic institutions to establish capacity both to conduct and to collect descriptive and prescriptive research in a comprehensive and systematic way. Study of the many issues raised in this paper (and many more outside of it) is surely appropriate. But it is also necessary to understand these problems holistically—to comprehend the systematic interrelationships that actions on one set of issues may have on other pertinent institutional investor problems. Although research is certainly being conducted on institutional investors in a variety of settings, we are aware of no academic or think-tank center leading a comprehensive approach to this vital area. Surely the time for such a comprehensive approach has arrived.

The hope for sound public policy or sound private ordering to address increasingly salient issues posed by institutional investors depends on this type of intellectual and institutional effort.

APPENDIX I.

Top Hedge Funds, Mutual Funds, and Pension Funds

TOP TEN HEDGE FUNDS IN THE AMERICAS

Firm	AUM ($ billions)
Bridgewater Associates	50.9
JPMorgan	41.1
Paulson & Co.	31.0
Soros Fund Management	27.0
Och-Ziff Capital Management Group	25.3
BlackRock	22.8
Angelo, Gordon & Co.	22.7
Baupost Group	22.0
Farallon Capital Management	20.0
King Street Capital Management	19.3

Source: *AR Magazine*
http://www.businessinsider.com/the-biggest-hedge-funds-in-the-us-2010-10#ixzz1TL9tRIVv

TOP TEN U.S. MUTUAL FUNDS, June 30, 2011

Mutual Fund	AUM ($ billions)
PIMCO Total Return	243.2
Vanguard Total Stock Market Index	170.0
Growth Fund of America	162.4
American EuroPacific Growth	116.2
Vanguard 500 Index	111.2
Vanguard Institutional Index	98.4
Vanguard Total Bond Market Index	90.2
American Capital World Growth & Income	84.2
American Capital Income Builder	82.0
Fidelity Contrafund	79.9

Source: Investor’s Business Daily, Investors.com, June 30, 2011.

http://www.investors.com/popup.aspx?DocID=577064

TOP TEN U.S. PENSION FUNDS, December 31, 2009

Pension Fund	AUM ($ billions)
Federal Retirement Thrift	234.4
California Public Employees	198.8
California State Teachers	130.5
New York State Common	125.7
Florida State Board	114.7
New York City Retirement	111.7
General Motors	99.2
Texas Teachers	91.4
AT&T	80.2
New York State Teachers	77.6

Source: Towers Watson, "T&I/300 Analysis, Year End 2009," September 2010.

http://www.towerswatson.com/assets/pdf/2728/PI-TW-300-survey.pdf

APPENDIX II – Select Associations of Institutional Investors in North America

Canadian Coalition of Good Governance

http://www.ccgg.ca

Committee on Investment of Employee Benefit Assets (CIEBA)
http://www.afponline.org/cieba

Council of Institutional Investors (CII)
http://www.cii.org

Interfaith Center on Corporate Responsibility
http://www.iccr.org

International Corporate Governance Network (ICGN)
http://www.icgn.org/

Investment Company Institute
http://www.ici.org

Investor Network on Climate Risk
http://www.ceres.org/incr/

Mutual Fund Directors Forum
http://www.mfdf.org

National Association of State Retirement Administrators (NASRA)
http://www.nasra.org

Pension Investment Association of Canada
http://www.piacweb.org/

APPENDIX III – Participants in the 2011 Aspen/CED/ Millstein Roundtable

The following individuals participated in the roundtable that took place at the offices of Weil Gotshal & Manges in New York on January 19 2011. Note that each contributed to the discussion as individuals rather than representatives of any institution. Moreover, their listing here implies no endorsement of the perspectives set out in this paper, which is solely the responsibility of the co-authors.

Larry Beeferman, Harvard Law School

Rebecca Darr, Aspen Institute Business & Society Program

Stephen Davis, Millstein Center for Corporate Governance and Performance, Yale SOM

Maureen Errity, Deloitte

Jonathan Feigelson, TIAA-CREF

Fabrizio Ferri, NYU Stern School

Peggy Foran, Prudential Financial

Nolan Haskovec, Deloitte

Jim Hawley, Saint Mary's College of California

Ben Heineman, Jr., Harvard Law School

Henry Hu, University of Texas at Austin School of Law

Matthew Lepore, Pfizer

Jon Lukomnik, IRRC Institute

Ira Millstein, Millstein Center for Corporate Governance and Performance, Yale SOM

Donald Peterson, Avaya (Ret.)

Judy Samuelson, Aspen Institute Business & Society Program

Kurt Schacht, CFA Institute

Elliot Schwartz, Committee for Economic Development

Anne Simpson, CalPERS

Jim Shinn, Princeton

Jennifer Taub, UMass, Amherst

Ed Waitzer, Stikeman Elliott

John Wilcox, Sodali

Endnotes

1 The Conference Board, *The 2010 Institutional Investor Report: Trends in Asset Allocation and Portfolio Composition* (New York: Conference Board, 2010). The percentage of UK equity markets held by institutional investors is comparable. See, Simon CY Wong, "Why Stewardship is Proving Elusive for Institutional Investors." *Butterworths Journal of International Banking and Finance Law,* (July/August 2010), p. 406.

2 See, for example, The Dodd–Frank Wall Street Reform and Consumer Protection Act (Pub.L. 111-203), Sections 951-56 and 971-72. The Dodd-Frank Act includes provisions on: "say" on executive pay, increased access to ballots for the election of directors, prohibition on brokers voting without receiving instructions from beneficial owners plus new disclosure on, among other things, risk, compensation and leadership structure. Similar steps may be seen in other jurisdictions in, for instance, stewardship codes in the UK, the Netherlands and South Africa.

3 See, *e.g.*, Stephen Davis, Jon Lukomnik, David Pitt-Watson, "Active Shareowner Stewardship: A New Paradigm for Capitalism," *Rotman International of Pension Management* (Fall 2009).

4 As John C. Coates IV has written in a draft discussion paper: "Empowering 'shareholders' without further reforms at the level of institutional ownership may be worse than the status quo. As institutional owners grow more important in the markets, and more powerful relative to corporate managers, it is that set of agents that are increasingly likely to be the source of future scandals and short-comings, ranging from the ordinary shirking of responsibilities to conflicts of interest as in 'pay to play' scandals to more subtle conflicts such as use misuse of soft information in positional power for private ends." See, "Corporate Governance and the Financial Crisis" discussion paper, February, 2010, available at http://www.law.columbia.edu/null/download?&exclusive=filemgr.download&file_id=154842

5 Wong, "Why Stewardship Is Proving Elusive for Institutional Investors," p. 408.

6 Dominic Barton, "Capitalism for the Long-Term," *Harvard Business Review,* (March, 2011); Henry Kaufman, *The Road to Financial Reformation: Warnings, Consequences, Reforms* (New York: John Wiley & Sons, 2009).

7 Roger L. Martin, *Fixing the Game: Bubbles, Crashes and What Capitalism Can Learn from the NFL,* (Boston, MA: Harvard Business Review Press, 2011).

8 Wong, "Why Stewardship Is Proving Elusive for Institutional Investors," p. 406; Ben W. Heineman, Jr, "Shareholders: Part of the Solution or Part of the Problem," The Atlantic (October 28, 2009), http://www.theatlantic.com/politics/archive/2009/10/shareholders-part-of-the-solution-or-part-of-the-problem/29188/; Richard Lambert, "Sir Ralph's Lesson's on How to End Short-Term Capitalism," *Financial Times,* May 23, 2011, p.11. ("…investors place irrationally low values on the returns from long-term investment projects….this short-termism is a market failure of the sort that raises big issues of public policy", summarizing paper by Bank of England analysts Andrew Haldane and Richard Davies, cited at note 36, infra.)

9 Davis et al., "Active Shareowner Stewardship: A New Paradigm for Capitalism," P. 11.

10 Roger W. Ferguson, "Riding Herd on Company Management," *Wall Street Journal*, April 27, 2010, http://online.wsj.com/article/SB10001424052702303695604575182152372360976.html?KEYWORDS=Roger+W+Ferguson+Jr.

11 Ben W. Heineman, Jr, "A 'Stewardship Code' for Institutional Investors," *Harvard Business Review,* January 18, 2010, http://blogs.hbr.org/cs/2010/01/a_stewardship_code_for_institu.html

12 Prior to publication, this paper was circulated for comments to attendees and other experts.

13 We also recognize that debt holders may have significant voice/impact on the direction of corporations, but have chosen to focus on "shareholders" because, in theory, they have a formal voice in the governance of corporations under incorporation and because this subject is complex enough on its own.

14 Brian K. Bucks, Arthur B. Kennickell, Traci L. Mach, and Kevin B. Moore, "Changes in U.S. Family Finances from 2004 to 2007: Evidence from the Survey of Consumer Finances," *Federal Reserve Bulletin*, vol. 95 (Feb. 2009) pp. A1-A55.

15 The Conference Board, table 12.

16 U.S. Department of Labor, Employee Benefits Security Administration, "Abstract of 2007 Form 5500 Annual Reports," *Private Pension Plan Bulletin* (June 2010), Table A1, pp.1-3.

17 Investment Company Institute, *2010 Investment Company Fact Book* (2010), Figure 1.10, p. 16 <http://www.ici.org/pdf/2010_factbook.pdf>.

18 National Association of Insurance Commissioners. (Private communication.)

19 For gross hedge fund numbers see The Conference Board, Table 21, p. 50. Note: the number of hedge funds trading equities is not known.

20 The Conference Board, Table 23, p. 57.

21 Barton, "Capitalism for the Long Term." John Bogle believes that the average holding period in 2009 is closer to 5 months, in John Bogle, "Restoring Faith in Financial Markets," *Wall Street Journal,* January 19, 2010.

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In announcing Professor Kay's independent review the Department said it "will examine investment in UK equity markets and its impact on the long-term performance and governance of UK quoted companies. This includes the actions of boards, shareholders and #their agents; the impact of rules and practices; and the level of transparency and engagement in the investment chain. The review will also consider the impact of increasing fragmentation and internationalisation of UK share ownership."

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