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The Political Economy of Investor Protection

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The Political Economy of Investor Protection

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An abstract of a dissertation submitted to the Faculty of the Graduate School of Emory University in partial fulfillment of the requirements for the degree of Doctor of Philosophy in Political Science 2009

Abstract

The Political Economy of Investor Protection
By Andrew Kerner

Adequate legal protections for minority shareholders are a powerful determinant of capital market performance and economic growth, yet there is surprising variation across countries and across US states in the extent to which minority shareholders are protected from rent-seeking by corporate insiders. My dissertation seeks to explain this variation. On the basis of a formal model that builds on work by Grossman and Helpman (1996), Rogowski and Kayser (2002) and others, I hypothesize that the key drivers of corporate governance and securities law policies are 1) the vulnerability of incumbent governments to economic voting, which is itself a function of political institutions, 2) competitive pressures to attract investment capital by enacting shareholder-friendly laws and 3) the role of institutional investors, particularly large pension funds, in the lobbying process.

I test my hypotheses in three substantively and methodologically distinct empirical chapters. The first of these chapters (chapter 4) features a series of large-N, cross-national statistical tests that evaluate the impact of political institutions, competitive diffusion and funded pension assets on the adoption and enforcement of insider trading laws and the extent of shareholder voting rights,

My dissertation's remaining empirical chapters examine the role of pension funds in the policy making process in more detail and with more analytical clarity. The first of these chapters (chapter 5) is a statistical analysis of state employee retirement funds' impact on US-state-level anti-takeover legislation during the 1980s and early 1990s. The second of these chapters (chapter 6) is a qualitative, interview based case study exploring the role of Polish pension funds in a recent flurry of corporate governance and securities law reforms in that country. Like their American counterparts, these pension funds are extremely large. Relative to the size of the Polish stock market, the largest of them are 2-3 times as large as the largest American pension funds. Unlike their American counterparts, however, Polish pension funds have been passive in corporate governance issues. I argue that the regulatory regime they face incentivizes these pension funds to be as passive as they have been.

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Chapter 1 – Introduction

> The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own.... Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.
>
> Adam Smith, The Wealth of Nations 1776

Corporate governance and securities law – collectively known as "investor protection" - determine the division of authority within public corporations between managers, minority shareholders, majority shareholders, labor and other stakeholders. Corporate governance rules and securities laws either succeed or fail to allow outside investors to act as a check on corporate insiders, whose positions often provide substantial opportunities for rent seeking. The ability of outside investors to act as a check on the actions of corporate insiders is *the* key mechanism that allows these investors to protect the value of their investment. The consequences to investors and the economy as a whole can be severe when corporate governance rules fall short. Prominent examples include:

- The corporate board of the Russian energy giant Gazprom reportedly stripped the firm and its shareholders of over $5 billion in natural gas assets[1] by selling gas at a steep discount to Itera, a separate firm owned by several board members' families. This is a classic case of "tunneling" wherein corporate value is transferred from the shareholders of one firm to another firm, typically one closely held by corporate insiders of the first

[1] This is roughly equal to the economic size of the entire Nike corporation in 2007.

firm or related parties, and typically at a steep discount.

● Calisto Tanzi, the founder and former CEO of Parmalat hid enormous losses from investors and embezzled hundreds of millions of Euros for himself and his family. Parmalat investors lost billions of dollars as a result.[2]

● Enron's well chronicled financial fraud robbed employee-investors of millions in retirement fund assets. Less well known is that Enron's collapse triggered enormous loses in public employee pension funds across the United States. The Florida Retirement System lost $325 million; the University of California Retirement System and public employee retirement funds in Georgia, Ohio, New York City and Washington all suffered losses over $100 million (Williams 2002).

Enron, Gazprom and Parmalat are extreme examples, of course. More common forms of corporate governance failure include empire-building, over-compensation of managers, unfavorable related party transactions, use of anti-takeover devices and other practices that increase the wealth of some corporate insiders, but lower firm value at the expense of minority shareholders. Yet the "smallness" of these more routine examples of managerial rent-seeking is misleading. In the aggregate these practices rob shareholders of untold billions.

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[2] Unlike Gazprom's board members, Calisto Tanzi has been prosecuted by American and Italian authorities and had to pay back millions in class action suit settlements and could face up to 15 years in prison. To underline the different reactions, William Browder, CEO of the Hermitage Capital Management hedge fund that is seeking redress from Gazprom and other Russian firms, has been expelled from Russia as an "enemy of the state" (Kochan 2006).

Improving levels of investor protection has become a topic *de jure* among policy makers, business leaders and international financial organizations. As the epigraph above suggests, however, the agency problems inherent to the public corporation have been clear for centuries, perhaps as far back as the Dutch East India Company (the world's first publicly held corporation), which, in its first ten years of existence, reneged on its commitment to investors to publish its initial 10 year annual account and resorted to paying dividends in spices rather than currency (Fergusson 2008:131). The Asian financial crisis of 1997, the Enron and WorldCom collapses of 2002, and the 2007-2008 financial crisis have all trained the public eye on this usually unnoticed topic.

After each prominent episode of corporate governance failure, mistrustful capital fled from countries and asset classes deemed too risky, creating severe economic dislocation for many, and prompting national and international policy makers to do something – *anything* - to solve the corporate governance problem. Even in the absence of a scandal, the last 30 years have been something of boom time for corporate governance reform. France, Germany, Japan and other archetypal examples of countries with bank-driven, non-shareholder-centric models of corporate finance have taken meaningful steps towards promoting the rights of minority shareholders by adopting insider trading prohibitions, increasing shareholder voting rights, allowing the hostile takeover of prominent firms and implementing tax laws aimed at incentivizing banks to reduce their shareholdings (Höpner 2000, Tiberghien 2007, Aoki 2006).

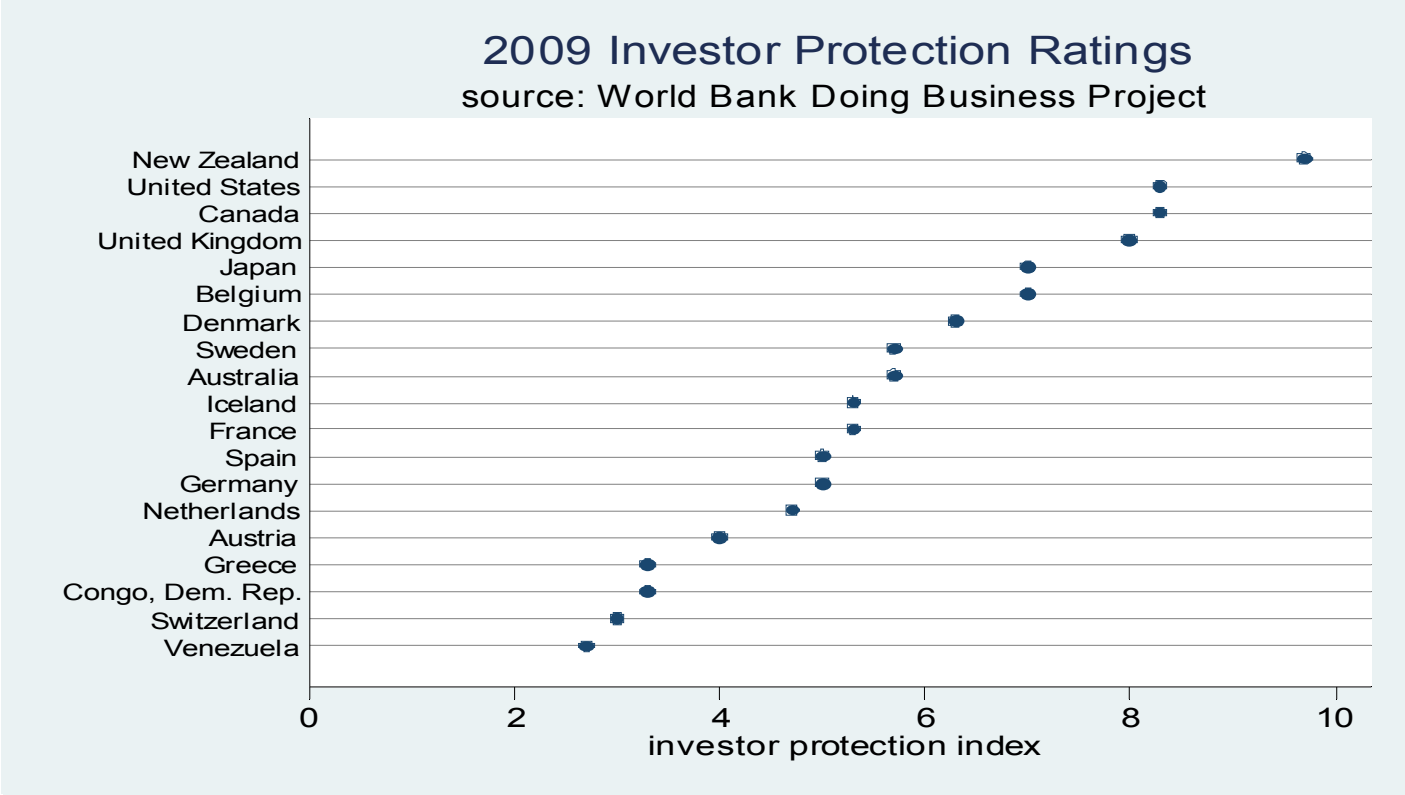
National policymakers, particularly democratically elected policymakers, have much at stake in corporate governance and securities law. Naturally, investors are drawn

to firms in countries with a consistently enforced, investor-friendly legal architecture. The extent to which countries can hope to attract foreign capital, retain domestic savings and encourage public firms to issue securities on local markets is deeply tied to the policy choices made by governments. Attracting this capital onto financial markets has crucial implications for national economic performance. Economists, including Demirgüç-Kunt and Maksimovic (1998), King and Levine (1993), and Levine, Loayza and Beck (2000) have shown that the financial development engendered by high levels of corporate governance leads to long-term economic growth.

Despite the consensus around the importance of investor-friendly corporate governance rules and securities law, there has been and continues to be a significant amount of cross-national variation in the extent to which minority shareholders interests are protected. Figure 1.1 shows the 2009 rankings of investor protection among high income democracies as complied and reported by the *Doing Business* project of the World Bank.[3] I have included several non-democracies for the sake of comparison. These ratings, which were compiled for 178 countries, are scaled from 0 to 10, with ten indicating the highest levels of investor protection. The Investor Protection Index is composed of three sub-indices: mandatory disclosure of related party transactions, the extent of legal liability for company directors, and the legal standing of shareholders in the event of a violation. As can be seen, there is considerable variation, even among high income democracies. Some countries – Netherlands, Austria, Greece and Switzerland - not only lag behind other high-income democracies, *they are among the lowest in the world. Switzerland falls in between the Democratic Republic of Congo and Venezuela,*

[3] Available at www.**doingbusiness**.org.

Figure 1.1


2009 Investor Protection Ratings
source: World Bank Doing Business Project
New Zealand
United States
Canada
United Kingdom
Japan
Belgium
Denmark
Sweden
Australia
Iceland
France
Spain
Germany
Netherlands
Austria
Greece
Congo, Dem. Rep.
Switzerland
Venezuela
0
2
4
6
8
10
investor protection index

not countries typically known for a commitment to shareholder friendliness![4] This begs the central question of my dissertation: If high levels of investor protection are so beneficial, why doesn't every country enact policies that protect investors?

1.1 Towards A Political Explanation of Investor Protection

The most prominent explanation for variation in corporate governance policy is "law and finance" theory originally posed by La Porta et al. (1998, 2000). The law and finance approach focuses on whether a country bases its legal system on common law (the British legal system) or civil law (best exemplified by the French legal system). The key distinction is that common law allows judges great latitude to create and update laws through judicial precedent, while civil law judges are considerably more constrained. Consequently, under civil law, "a corporate insider who finds a way not explicitly forbidden by the statutes to expropriate outside investors can proceed without fear of an adverse judicial ruling" (La Porta et al. 2000: 9).

The legal heritage argument is a controversial one, and has been challenged by numerous academics across several disciplines (ex. Gourevitch and Shinn 2005, Rajan and Zingales 2000, Roe 2003, Spamann 2006). One glaring limitation is that legal heritage is a static variable, yet many countries' corporate governance and securities law regimes have changed considerably over time By definition, legal heritage cannot explain these "great reversals" (Rajan and Zingales 2003). Another important limitation

[4] This table also suggests the importance of measures of investor protection that includes enforcement, as well as laws on the books. Clearly, Switzerland is a safer place to put your money than the Democratic Republic of Congo. This issue is taken up in chapter 4.

of the legal heritage argument is that it cannot be used to explain sub-federal variation among political units that, by definition, share the same legal heritage. However, the most important limitation of the legal heritage argument is that it is apolitical. It ignores completely the role of interest groups and politicians in shaping the law, and the various incentives that they may or may not have for advancing a particular policy platform.

In the decade since La Porta et al. first proposed their theory, a variety of economists, political scientists and legal scholars have advanced alternative, political theories to explain variation in corporate governance practices. These political theories begin by acknowledging that the broad gains from investor-friendly corporate governance rules and securities laws come at the expense of corporate insiders who lose out on rent-seeking opportunities. In general, these political theories argue that whichever groups – managers, majority shareholders, minority shareholders, the public, etc – holds the greatest sway with policy makers will be able to achieve their desired policy outcome. As such, these theories of corporate governance reflect distributional conflicts that have long been a staple of political economics.

Some of these political theories of corporate governance rely on partisan explanations, arguing that labor interests, which are arguably better served in the absence of a market for corporate control, will be more influential in left-leaning social democracies (ex. Roe 2003). Others have argued, as in the varieties of capitalism literature, that the ability of labor and management to able to forge long-term, "corporatist coalition" against investor-friendly corporate governance standards is key (ex. Gourevitch and Shinn 2005; Pagano and Volpin 2001 Hall and Soskice 2001). Other

have argued that the existence of large institutional investors, particularly pension funds, can play the key role in tilting the balance of domestic power towards shareholders (ex. Gourevitch and Shinn 2005, Gourevitch 2007, Bebchuk and Neeman *forthcoming*). While these theories are instructive in a variety of ways, and undoubtedly have considerable explanatory power in many cases, recent research suggests that they are incomplete (ex. Cioffi and Höpner 2005, Culpepper forthcoming). In this dissertation I focus on two areas that are particularly incomplete in the extant literature: the role of the public interest and the role of pension funds in driving variation in investor protections.

1.2 Argument And Contributions

I base my theory of investor protection on Grossman and Helpman's (1994, 1996, 2001) model of trade politics. In my model government is the ultimate arbiter of policy, and shareholders and corporate insiders each lobby to promote corporate governance policies that are in their own interests. For shareholders, such policies are assumed to be the high levels of corporate governance that improve the returns on their portfolios, while corporate insiders are assumed to lobby for lower levels of corporate governance that maximize their incomes, including income from rent seeking based on their insider status. The core tension faced by politicians is how to balance the the contributions of interest groups against their own electoral interest in the economic welfare of the voting public.

This dissertation is not the first appropriation of the Grossman Helpman framework to explain corporate governance outcomes. Bebchuk and Neeman

(forthcoming), Perotti and Volpin (2008) Scarsciatini (2002) have all used variations of this theoretical model to explain similar policy outcomes. The value added of this dissertation is to look deeper into some of the questions that arise from this model. When will government be responsive to the public interest? When will pension funds, considered by many to be shareholders' only real hope of overcoming collective action problems, be able to serve as an effective shareholder lobby?

In addressing these question I make two important arguments. First, contemporary corporate governance policymaking is as much about international competition as it is about domestic politics. The fall of Bretton Woods-era capital controls allowed capital to cross borders more easily. This allowed domestic capital to flee markets where it could not earn a sufficient return, placing pressures on governments to cater to the needs of the investor community more so than in the past. Countries began to compete for internationally mobile capital in ways they could not have before, allowing capital starved markets to aid their case by adopting policies in favor of investors' interests.

This has important, and generally overlooked, implications for the nature of the public interest in investor protection. The argument that there is a public interest in corporate governance and securities law is effectively one about economic competitiveness. In modern economies with functioning capital markets, retaining investment from domestic sources and attracting capital from foreign investors is a key part of economic development. Because investment decisions, particularly those made the large institutional investors, are often sensitive to corporate governance standards,

policy decisions made over corporate governance issues can have considerable implications for the economic welfare of the average citizen and, by extension, for their voting choices. In a world where countries compete over capital, the salience of investor protection for economic performance can be stated in relative as well as absolute terms. Countries don't just need to protect investors, they need to protect them *more* than their competitors. We know, however, that international competitive pressures are not distributed evenly across space and time, and the precise vectors of diffusion - the definition of "space" - are often specific to the policy in question (Beck Beardsley and Gleditsch 2006, Simmons and Elkins 2004; Elkins, Guzman and Simmons 2006).

Moreover, recent literature including Basinger and Hallerberg (2004), Brooks (2005) and Brooks and Kurtz (2007) have noted the mediating effect that domestic institutions have on competitive diffusion processes. In other words, simply having a public interest is not enough to provoke policy change. What is needed is a domestic political structure that aligns the public interest with the political self-interest of elected officials. Rogowski and Kayser (2002) provides useful insight into how this alignment takes place. Because the electoral implications of a shift in votes - the seat vote elasticity – is highest under majoritarian electoral rules, I expect governments elected using majoritarian to be more sensitive to corporate governance's economic and, therefore, electoral implications. In sum, I argue that he salience in public interest in investor protection is a function of international competitive pressures, domestic electoral law and their interaction. I test these hypotheses in a series of quantitative tests in chapter 4.

My second contribution focuses on the role of pension funds. The prominence of

pension funds in the global financial economy has risen massively over the last 35 years. This rise can be attributed to demographic trends as well as policy changes, particularly the 1974 Employment Retirement Incomes Security Act (ERISA) and related policies in the United States, and the wave of pension reforms, beginning in Chile in 1981, which have channeled a massive amount of savings in Latin America and Eastern Europe into their stock markets. Together, these policy shifts unleashed a massive amount of investment capital in search of safe investments.

While the role of pension funds in corporate governance issues has long been recognized in the literature, less noted is that pension funds vary considerably in their actual political behavior. Some pension funds- most notably CalPERS, TIAA-CREF and Hermes UK - have made corporate governance a major priority and have asserted themselves in political debates, conditioned their investment strategies on firm and country level corporate governance policies, and leveraged their large equity stakes as a vehicle for influencing the management of the firms they invest in. Gourevitch and Shinn (2005) have noted similar behavior by Dutch, Malaysian and other pension funds. Others, including the pension funds created by pension reform, have remained considerably more docile.

Most work on this topic treats pension funds as an undifferentiated class of investors with homogeneous interests. Only very recently have analysts begun to recognize the differences among pension funds in their willingness and propensity to engage in corporate governance issues. In the most general terms, pension funds need not just be present, but also properly incentivized. I argue that the key factors that lead

pension funds to engage in the policy making process are 1) owning a large enough share of the market that they can profit from their political activism, and 2) operating in a legal and competitive environment that incentivizes pension funds to prioritize the returns on their portfolios in the first place. Considerably more work in this area is needed, and this dissertation contributes to this burgeoning literature. Chapters 4 and, to a greater extent, 5 and 6 examine the influence of pension funds on policy outcomes, and the wide variation of behaviors that we observe among pension funds.

While the immediate aim of this dissertation is to better articulate the political-economic antecedents of corporate governance policy, it also aims to contribute to the political economy literature more generally. This dissertation addresses core political-economy questions. What are the policy consequences of domestic political institutions? How do international competitive pressures impact policy decisions? How and when do interest groups assert themselves in the policy making process? In this sense, I am using corporate governance and securities law as a laboratory to observe political phenomenon with much broader implications. Because corporate governance policy has so many implications for so many actors – government, voters, interest groups – and speaks to so many political phenomenon – interest group lobbying, cross-national competition, economic voting – I believe it is a particularly rich laboratory for such efforts. Many of these dynamics are common to issue areas that are more commonly written in political science and it is therefore my intention to create a work whose conclusions can be easily applied to other mainstream works in the discipline. Several of the conclusions I draw can be stated at the outset.

- Domestic political institutions matter. They shape government's incentives to cater to the public rather than the private interest.
- The impact of domestic political institutions cannot be viewed in isolation of international competitive pressures. While certain electoral rules may dampen reactivity to the public interest, no democratic government is immune from these pressures. In a world in which capital can easily flee borders for markets that promise a safer investment environment, all democratically governments are ultimately responsive to severe competitive pressures.
- Not all interest groups are created equal. Different legal and competitive environments can drastically alter the incentive structure and resulting political behavior of interest groups that, from a sufficient distance, appear to have homogeneous interests. In order to understand the likely impact of an interest group, it is not enough to simply note their presence, but also to note how their presence interacts with their incentive structuring environment.

1.3 Plan of the Dissertation

The remainder of this dissertation is as follows. Chapter 2 reviews the literature on the political and economic determinants of variation in investor protection. Chapter 3 presents a formal model of my theory, its equilibrium solution, and enumerates the hypotheses to be tested.

Chapters, 4, 5 and 6 are empirical. In chapter 4 I explore the political determinants of variation in shareholder voting rights and the worldwide diffusion of insider trading laws through a series of quantitative tests. The appeal of these two variables is that, collectively, they reflect both corporate governance policy and securities law. Moreover, both variables speak directly to the distributional consequences between insiders and outside investors, and both have been shown in the quantitative literature to covary with economic outcomes in the way envisioned by my theory. Of particular note, insider trading laws have statistical qualities that allow for far more precise insights into the political and economic conditions that engender high levels of investor protection than either shareholder voting rights or any other variable used in the extant literature.

Section II focuses more specifically on pension funds and the various incentives or disincentives they face to engage in corporate governance activism. In chapter 5 I explore the political behavior of American pension funds, particular the large, state level retirement systems that have historically dominated pension fund influence on American corporate governance. The American funds, particularly CalPERS, have become icons of the corporate governance movement, and are undoubtedly the image many analysts have in mind when they speak of "activist funds". The empirical content of this chapter is particularly focused on state-level anti-takeover law battles of the 1980s and early 1990s, taking advantage of a particularly rich data set available form the US Census Bureau on the size and asset class allocation of state pension fund holdings. I examine the determinants of "second generation" and "third generation" anti-takeover laws, using a supreme court ruling - *Edgar v. MITE Corp.(1982)* – as a natural experiment in order to

avoid what would otherwise present endogeneity problems.

In chapter 6 I explore the impact of Open Pension Funds (Otwatry Fundusz Emeraltalny, or OFE) on recent corporate governance reforms in Poland. OFE pension funds are the creation of Poland's 1999 pension reform, which followed closely on the earlier Chilean reforms. OFE pension funds currently make up the largest source in institutional capital on the Polish market. Moreover, the pension fund market in Poland is top heavy, with some of the larger funds owning a considerably greater share of the Polish market than any American pension funds, including CalPERS, own of the American market. In that sense, one might naively expect the largest of these funds to behave as the largest American funds do, by engaging in corporate governance activism of various sorts. OFE pensions are, however, subject to a variety of regulatory measures and competitive pressures, typical for pension funds modeled on the Chilean reform, that limit their willingness to engage in corporate governance debates. Chapter 6 explores these how this incentive structure manifests itself in pension fund behavior. The insights drawn in chapter 6 are the product of several months of qualitative research, conducted under the auspices of Ernst and Young Poland's Better Government Programme.

Chapter 7 concludes by summarizing my arguments and noting several areas of potentially fruitful future research in the politics of corporate governance.

Chapter 2 - Literature Review

Most of the literature on corporate governance and investor protection uses investor protection as in independent variable used to explain financial development and, in turn, economic growth. Bagehot (1873); Hicks (1969); Levine (1999); Kletzer and Bardhan (1987) Castro Clemente and MacDonald. (2004), Beny (2005); Becker and Greenberg (2003); Demirgüç-Kunt and Maksimovic, (1998); King and Levine (1993); Levine, Loayza and Beck 2000; Svaleryd and Vlachos (2005) all demonstrate that higher levels of investor protection are associated with positive economic outcomes of various sorts, ranging from more efficient capital markets, higher share prices, better terms of trade, and more financial development. An obvious follow-up question that has only recently been asked is: Given the benefits, why do some countries have investor friendly laws while others do not? The works summarized below attempt to answer this question.

2.1 Law and Finance Theory

The first and most influential theory that has been used to explain differences in investor protection is the "law and finance" explanation suggested by La Porta et al. (1998). This work is referenced in virtually every subsequent work on investor protection and expanded upon in various successor projects by the original authors and others (ex. Beck, Demirgüç-Kunt, and Levine 2003, Djankov et al. 2008, Djankov, McLeish and Shleifer

2007, La Porta, Lopes-De-Silanes and Shleifer 2008). Law and finance theory focuses on legal heritage. The key insight made by law and finance theory is that countries rarely develop their legal systems from whole cloth. Rather, countries tend to have adopted (through colonization or other means) one of a relatively small group of legal systems. One prominent legal system is common law, which operates in the United Kingdom and in most former British colonies, including the United States and Canada. The major alternative to common law is civil law, which operates, in one or another of its several variants, in the majority of the world's countries.[5]

The main difference between common law and civil law is that common law relies on judges to create a body of law that is to be respected in future cases (*stare decisis*). In civil law systems, by contrast, rule making falls entirely to the legislature; the role of judge is simply to apply these laws. Law and finance theorists argue that common law's emphasis on the judicial role in law making allows those countries to protect investors better because they can more easily update laws and apply them to quickly evolving dynamics in the business world. Judges in civil law countries lack this latitude and, as a result, managers can more easily find new ways to expropriate from shareholders that remain within the letter, if not the spirit, of the law (La Porta et. al. 2000).

Despite its influence, law and finance theory has been heavily criticized (ex. Rajan and Zingales 2003, Gourevitch and Shinn 2005, Roe 2003, Spamann 2008). Two

[5] These clusters within civil law include the French variant , which was spread spread through Europe by Napoleon and throughout the world by French and Spanish colonial empires. French civil law is used in France, Belgium, Spain and the majority of Latin American, East and South East Asian and African countries. The German variant of civil law operates throughout much of central Europe, as well as Japan. A Scandinavian variant is used throughout that region. Other legal codes – Sharia Law, or socialist based legal codes – are also used in some countries.

of these critiques are particularly relevant for this dissertation. First, legal heritage is a static variable. States adopted (or, more commonly, were forced to adopt) one or another legal codes in the distant past, well before politicians or anyone else was concerned about or cognizant of different legal codes' implications for stock market development . While this feature allows the legal heritage variable to be very plausibly exogenous, it severely limits is explanatory capability. Legal heritage cannot explain changes in investor protections within countries over time; what Rajan and Zingales (2003) term the "great reversals." These shifts are both common and substantively important.[6]

A second line of critique that has been leveled at law and finance theory is that is is apolitical. Law and finance theory does not allow for investor protection to pit interests groups against one another, or for politicians to resolve these issues according to their own best interests. This is to say that law and finance theories does not engage *politics* as it is traditionally understood in political science. In this, law and finance theory is not alone. Stulz and Williamson (2003), Glaeser, Johnson and Shleifer (2001), Dyck and Zingales (2002, 2004) all promote theories of investor protection that avoid the political wrangling between interest groups in society and government as a driver of public policy.[7]

This dissertation should not be interpreted as a refutation of the importance of

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[6] In particular, see Rajan and Zingales' (2003) discussion of changes in the French financial system and Perotti and von Thadden's (2006) discussion of post war reversals across Europe

[7] Stulz and Williamson (2003), argue that religious differences, and specifically the different tolerances that they bring towards charging interest, have had a larger impact on creditor rights than legal heritage has. Glaeser, Johnson and Shleifer (2001) argue that the importance of leaders' ideological stance towards regulating capital market operations. In a slightly more political argument, Dyck and Zingales (2002, 2004) argue that newspaper readership – and its ability to marshal public opinion against corporate insiders - plays a key role in protecting the legal position of shareholders.

legal heritage or other apolitical factors for investor protection policy.[8] However, there is much about investor protection that is not captured without recourse to politics. Contemplated changes in investor protection routinely invite lobbying by competing interest groups and maneuvering by politicians. The political theories of investor protection detailed below are not only a productive application of political economy theories to a policy area that, until recently, had not been addressed by the discipline, but also an accurate – more accurate, I would argue – way to describe variation in investor protection and how it has evolved.

2.2 Interest Groups Theories of Investor Protection

The key insight made by political theories of investor protection is that investor protection has different distributional consequences for different groups in society. Thus, it makes little sense to think of high levels investor protection as being "good" in a broad, universal sense. Rather, these works ask: for whom is investor protection good and for whom is it bad? To the extent that effective interest group lobbies are able to form, those groups that benefit from high levels of investor protection should lobby for more of it, while those that are hurt by high levels of investor protection should lobby for less. Political outcomes, in this view, are a function of which group dominates the market for public policy.

[8] This is not to say that such a refutation does not exist in the literature. Spamann (2008), for example, makes a particularly damning critique of law and finance theory, in which he argue that legal heritage lacks the statistical relationship to investor protection outcomes that La Porta et al. claim.

The primary distributional conflict implied by corporate governance depends on the distribution of ownership within the firms. In a firm owned by a diffuse set of small shareholders - the so-called Berle-Means firm, typified by ownership pattern in the United States and United Kingdom – corporate governance rules pit managers that prefer managerial autonomy over corporate strategy against owners that prefer to have meaningful oversight over the operations of firms that they own shares in. Strengthened corporate governance rules that increase the efficacy of this oversight can be used to deter managerial empire building, demand higher dividends, or to limit excessive managerial perquisites, such as exorbitantly high managerial wages and/or unjustified job security (ex. Bertrand and Mullnaithan 2003; Jensen 1986; Hope and Thomas 2008; Feldstein and Green 1983; La Porta et al. 2000). The historical record is replete with cases of managers operating under weak corporate governance rules that have used this autonomy to direct company funds towards investments that serve managerial, but not shareholder, interests (ex. Johnson et al. 2000; Glaeser, Johnson and Shleifer 2001; Bertrand and Mullnaithan 2003).

In the closely held firm, the agency problems are slightly different. In a firm with a controlling shareholder, there is a strong expectation that the controlling shareholder will have a large impact on choosing the board of directors and take an active role monitoring management. The management- shareholder agency problem less of a concern is such a firm than it is when ownership is spread thinly across many shareholders. However, the majority shareholder presents agency problems of his or her own. Given the accountability to a single voter or voting bloc, the fealty of of the

corporate board and management to the majority shareholder can be expected. Majority shareholders have incentives to abuse this fealty by appointing (and overpaying) friends and family to work as management, or contracting with related parties using contracts that benefit the related party at the expense of firm. The key agency problem in a closely held firm is between the majority and minority shareholder. Corporate governance rules that mandate independent board members, cumulative voting for board seats and similar laws are therefore particularly important in the closely held firm.

Setting securities law provokes a similar distributional conflict between management and shareholders in the Berle-Means firm and the closely held firm. In the presence of weak securities laws, corporate insiders – whether they are managers or majority shareholders - can use their informational advantages to prey on outside holders of corporate securities. This can happen by reporting fraudulent or incomplete financial statements to minority shareholders, subverting the independence of auditors or by using private information to trade securities at the expense of investors that rely on public information. Tightening securities law typically raises market values, but at the expense of insiders, whose rent seeking opportunities are limited.

Thus, an observed set of corporate governance standards or securities laws reflect a division of wealth between management and majority and minority shareholders. When corporate governance standards are low or when securities laws are lax, corporate insiders are more able to leverage their position within the firm to profit at the expense of minority shareholders. When corporate governance standards are high or when securities laws promote a fair and transparent trading environment, minority shareholders are better

able to ensure that their wealth is maximized.

2.2.1 A Role for Labor?

While the conflict between mangers and majority and minority shareholders is central to political theories of investor protection, so too is labor's role. Managing a firm in order to maximize shareholder value often means reducing a firm's wage bill – either through layoffs or pay cuts. An active market for corporate control, which typically accompanies high levels of investor protection, is often not conducive to long-term, stable employment. For these reasons, investor protection is typically thought to be anathema to labor's interests and labor often features prominently in models of interest group theories of investor protection (ex. Gourevitch and Shinn 2005; Pagano and Volpin 2005; Perotti and Von Thadden 2003, 2006; Roe 2003).

Despite the prominent role that labor's supposed antipathy towards investor protection plays in many theories, the empirical record is considerably muddled. Recent case studies reveal that many prominent corporate governance and securities law reforms have been led by left and center-left parties with strong labor constituencies (Deeg 2005; Cioffi and Höpner 2006; McCann 2007; Culpepper 2007). Callaghan and M. Höpner (2005) examine voting patterns in European parliament on the on the 2001 EU takeover directive and find that national distinctions between legislators trump partisan differences. Culpepper (forthcoming) notes that labor unions were decidedly disinterested in, and absent from, debates on revising the Dutch anti-takeover code.

Why the inability to find consistent evidence that labor unions and leftist, presumably pro-labor parties, oppose greater investor protection? It may be that labor is often vested in corporate or public pension plans that hold significant amounts of corporate equity in their portfolio.[9] To the extent that higher investor protection increases the value of their investment portfolios, labor's interest against investor protection may be tempered by their role as investors (Gourevitch and Shinn 2005). American labor union pension funds, for example, have become among the strongest advocates of pro-shareholder reform in the United States in recent years, arguably supplanting the role traditionally held by public employee pensions (ex. Schwab and Thomas 1997). It may be that leftist parties' representation of labor interests is trumped by their opposition to the insider arrangements between management, bankers and politicians that typify systems of "patient capital" (Cioffi and Höpner 2005). It may be that labor is primarily concerned with pro-growth policies that attract investment and expand job opportunities, rather than the legal environments used to promote such growth (Gourevitch, Pinto and Weymouth 2008). It may be that labor's involvement in corporate governance issues is conditional on the underlaying labor laws: if labor is protected from dismissal in the event of a corporate takeover, they may not see much reason to spend political resources contesting takeover laws, for example. If labor is sufficiently protected by a strong labor law, they may even prefer an active market for corporate control that pushes up share price and disciplines management in areas other than personnel management. It may finally be that labor does not care very much about investor protection, and, in practice,

[9] In some countries, particularly the United States, a significant percentage of workers also own shares through private accounts.

rarely lobbies their political representatives for or against it (Culpepper, forthcoming). It may be all of these things, but the theoretical and empirical support for the most common claims about labor interests and their role in the political debate over investor protection is notably ambiguous.

2.2.2 Lobby Formation

In the market for public policy, latent preferences are equivalent to no preferences at all. Mancur Olson's *The Logic of Collective Action* (1971) is the classic reference on the factors that allow societal groups to overcome the barriers to collective action and form effective lobbies. Olsen notes that the key barrier to collective action is the incentive for group members to "free ride" off the actions of others by sharing in the spoils of a public good without contributing to the costs of securing it. If a significant portion of an interest group chooses to free ride rather than bear the costs of organizing, the costs to the remaining members may be too high to justify the effort or the expense. The key to overcoming barriers to collective action are circumstances (whether they exist naturally or are brought into being by deliberate action) that lower the costs or raise the benefits of organizing. Small, pre-established and/or homogeneous communities generally face lower costs to organizing. High salience issues and/or the availability of selective benefits for organized members raise the benefits of collective action.

Of all of the groups in model, managers and majority shareholders should have the easiest time organizing. They have an obvious and profound interest in preserving

their autonomy within the firm. They are a relatively small group, and typically have pre-existing lobbying capabilities built up around issues beyond corporate governance, such as taxation, labor and environmental regulations, etc. Moreover, the actual costs of lobbying may be lower for insiders than for other groups because, as Bebchuk and Neeman (forthcoming) note, insiders are in a uniquely advantageous position of being able to use other people's (outside shareholders') money to lobby in favor of a policy environment in which they will be able to collect all of the spoils. In practice, groups representing management have been very active and very successful in lobbying on behalf of their own interests in low levels of investor protection (ex. Gourevitch and Shinn 2005; Culpepper *forthcoming;* Roe 1993, Romano 1987).

Can minority shareholders organize themselves into a successful lobby group? Individual investors are too diffuse and their stake in corporate equity too small to overcome barriers to collective action (ex. Berle and Means 1932; Black 1991; Bebchuk and Neeman forthcoming; Culpepper forthcoming). In practice, individual investors' are barely able to discipline managers through monitoring and voting within the firm, let alone organize to successfully lobby politicians (ex. Shleifer and Vishny 1986; Grossman and Hart 1980). Institutional investors face a different set of costs and benefits to collective action. Institutional investors are large investors that pool resources across many individuals and manage an investment portfolio of those funds. The main types of institutional investors are insurance companies, investment companies (typically, mutual funds) and pension funds. To give a sense of the size of these actors, figure 2.1 shows the financial assets of institutional investors in the France, Germany, Japan, the US and the

Figure 2.1


Financial Assets of Institutional Investors in 2000 as a % of GDP
source: OECD 2003
percentage of GDP
120
100
80
60
40
20
0
France
Germany
Japan
UK
USA
Insurance Companies
France
Germany
Japan
UK
USA
Investment Companies
France
Germany
Japan
UK
USA
Pension Funds

UK in 2000. In most developed markets, institutional investors dominate ownership of corporate equity. The enormity of their assets exposes institutional investors to huge losses if firms they have invested in are managed contrary to shareholder interests. Furthermore, while they are easily organizable (in theory and in practice), they are often large enough to influence policy on their own (ex. Hebb and Wojcik 2005; Jacoby 2007; Carleton, Nelson and Weisbach 1998).

Despite their abilities to organize, the interests of institutional investors are complex. Insurance companies and investment companies often do a considerable portion of their business selling financial or insurance products to the same firms they hold shares in. Their willingness to oppose management within in the firm, as well as in the political arena, is constrained by their desire to do business with these firms in the future (ex. Gourevitch 2007; Brooks 1975). Pension funds, on the other hand, face fewer of these conflicts. This is not to say the pension funds are entirely aligned with shareholder interests. Prior to labor departments' issuing of the Avon Letter in 1987 (more on which in chapter 5), corporate pension funds in the United States were almost entirely beholden to the interests of the sponsoring entity, and the fealty of corporate pension funds to their sponsor is a persistent fact even afterwards. Public pension fund Figure 2.1often hold positions in politically sensitive firms and may be constrained in their willingness (or ability) to oppose management by the sponsoring governments (ex. Romano 1988, Monks and Minow 2002). Despite these limitations, pension funds have been a powerful force in favor of greater investment protection within firms and in the market for public policy. CalPERS, one of the world's largest pension funds, has been

particularly active in lobbying governments around the world to increase their levels of investor protection, occasionally pulling their money out of a country if such changes in public policy are not made (ex. Hebb and Wojcik 2004, Rhodes and Apeldoorn 1998).

2.3 Putting The Pieces Together: Political Economy Models of Investor Protections

While identifying the relevant interest groups is an important first step towards understanding the politics of corporate governance, the crucial second step is to understand the political-economic environment in which they operate. One commonly adopted model is as parsimonious as it is potentially powerful: corporate insiders represent the most organized and influential interest groups, and their preferences will ultimately dictate policy (Culpepper *forthcoming*, Rajan and Zingales 2003, Romano 1987).

While the success of corporate insiders in protecting their rents is undeniable, most analysts do not see the inevitable domination of one interest group, but rather a contested political battles in which both side can and do occasionally win. To that end, a variety of theories focus on the political context in which interest groups compete. Roe (2003) argues that the key contextual factor is the presence or absence of a social democratic government that empowers labor and their supposed opposition to investor protection. Gourevitch and Shinn (2005) argue that the social democracy observed by Roe is not principally characterized by labor strength, but rather by a cross-class alliance

between labor and management. In other models, including, to an extent Gourevitch and Shinn's but particularly Hall and Soskice (2001), investor protections are one part of a larger set of interrelated policies – along with labor relations, banking, education and others – that, in the language of the varieties of capitalism literature, separate coordinated market economies (CME) from liberal market economies (LME). The premise of a CME is that actors make investments in skills, product market standards, production strategies, and firm to firm relationships that assume long term stability in the corporate landscape and in employment. An inactive market for corporate control is a necessary precondition for this stability. Importantly, this cross-interest group bargain also requires the political stability found in consensus-based government.[10][11]

Pagano and Volpin (2005) develop a four actor model (labor, managers, shareholders and a residual group of the unemployed and the self-employed) in which investor protection and employment benefits are jointly determined by election seeking politicians. The need to maximize votes under proportional representation leads politicians to aim their policies towards the most organized social groups - labor and management - both of whom oppose high levels of investor protection. Majoritarian electoral rules, on the other hand, lead politicians to aim their policy platforms towards marginal constituencies – swing districts – that, according to the model's assumptions, are heavily populated with shareholders and the residual group who lack a strong party identification and, to the extent that they hold shares themselves, support stronger investor protection.

[10] It should be noted that the "corporatist coalition" of labor and management against shareholders is just one of several coalitions that are possible for Gourevitch and Shinn (2005).

[11] A similar theory is put forward in Pagano and Volpin (2001) and early drafts of Pagano and Volpin (2005).

While these are all superlative works, recent reforms point to important limitations of their approach. First, the above theories rest (at least partially, in Gourevitch and Shinn's case) on assumptions about labor preferences, which, as noted earlier, are not as predictably anti-investor protection as these theories suggest. Second, works based on the varieties of capitalism literature can be particularly useful in explaining laws pertaining to corporate control, such as takeover law and the extent of co-determination, but are significantly less able to explain patterns of insider trading laws, prohibitions on related party transactions, disclosure rules and a variety of other policies that are central to shareholder's abilities to protect the value of their investment, but do not impact corporate control or threaten complementaries between industry, labor and education. Indeed, the variation noted in table 1 cannot be explained by the varieties of capitalism.

Third, government, in Gourevitch and Shinn's model is merely an arena for societal interests to pursue their preferred policies. In Pagano and Volpin's model, governments have no independent interest in investor protection beyond placating the expressed policy preferences of interest groups. But governments - particularly in democratic settings – have a clear stake in investor protections, and in the capital market outcomes that they inform, that is entirely separate from interest groups preferences as described in these works. As economic success has become increasingly coupled with capital market performance, incumbent governments ability to be reelected has also become tied to the provision of policies that increase capital market performance. Many reforms – Sarbanes Oxley in the United States in 2002, the Tabaksblatt in 2003 in the

Netherlands, the 2003 CalPERS-instigated reforms in the developing world, as well as more recent reforms in France, Korea, Japan – were all carried out explicitly because of their anticipated impacts on the general health of the economy and on capital market performance in particular (Hebb and Wojcik 2004; Cioffi and Höpner 2005; Tiberghien 2007). While interest groups played a key role in shaping each of these reforms, so too did a reelection motive that is not easily captured in the above noted interest group based theories.

2.4 Public Interest Models of Investor Protection

Several recent works explicitly incorporate the public interest into theories of investor protection. Perotti and von Thadden (2003, 2006) argue that high investor protection lowers the returns to labor while it increases the returns on financial capital. Drawing on the median voter theorem, the authors theorize that democracies in which the median voter relies more heavily on the returns to their labor than to their financial assets will have lower investor protection. Empirically, they argue that lower levels of investor protection in Europe and Japan relative to the US and UK can be traced to the (exogenous) destruction of financial capital during World War II, which effectively ensured that the median voter in the US and UK held a greater portion of their assets in financial capital.

This approach has its limitations. First, the median voter theorem was developed to apply to majoritarian elections (an assumption that the authors preserve in their formal

model), yet most of the European countries that eschewed shareholder capitalism following WWII adhered to various forms of proportional electoral rules. As Cox (1990) notes, proportional electoral laws are centripetal in that they draw politicians to favor groups outside of the political center. Moreover, under proportional electoral rules politicians must often form multi-party coalitions to govern; parties that do not necessarily compete for the median voter are often given a large role in setting policy – acting as "kingmakers" (ex. Austin-Smith and Banks 1988, Norris 1997). In short, there is little basis on which to assume that the median voter was the focus of policy attention in most of the countries Perotti and von Thadden examine.[12]

Bebchuk and Neeman (forthcoming) offer a theory that is closely aligned with "common agency" models of policy making. Bebchuk and Neeman argue that investor protection policy outcomes are a function of interest group politicking between corporate insiders, shareholders and entrepreneurs. Their model predicts that policies reflect the balance of power between these interests groups and their abilities to draw politicians away form their default, "socially optimal" policy, which is set at the point where the marginal cost to insiders equals the marginal benefit to shareholders. Voters are absent from their baseline model because "[they] largely do not follow this subject" (12). By implication, in the absence of a highly visible scandal, governments are held accountable to the public interest purely by their own benevolence.

Perotti and Volpin (2004, 2007) focus their model on the conflict between established firms' desire to maintain their market share against consumer and

[12] Moreover, even in those countries where the median voter theorem applies, the median voter was neither a shareholder nor an employee at a public corporation.

entrepreneurial interests in greater firm entry facilitated by high investor protection. In their model a lobbyist acting on behalf of established firms provides money to politicians in exchange for low levels of investor protection that favor incumbents by limiting firm entry. Their model predicts that greater public awareness of investor protection's importance, which is proxied in their empirical tests by newspaper readership, and greater political accountability to voters, which is proxied in their empirical tests by democracy, increases the electoral salience of consumer preferences and therefore increases the equilibrium levels of investor protection.

While their identification of democracy is clearly an important – likely *the* important - determinant of political accountability, simply looking at political democracy cannot explain the variation noted in table 1 that has motivated the investor protection literature and this dissertation. Why are the UK, the USA and Canada so different from Austria, Switzerland and the Netherlands? Democracy alone cannot be the answer.

While public interest based theories are beginning to take hold in the economics literature on investor protection, these issues are notably absent in work by political scientists. Part of the reluctance of political scientists to embrace public interest based explanations is also surely tied to the fact the public, even those who own stocks themselves, almost never make explicit demands for higher corporate governance standards or more stringent securities laws. Thus, contra Perotti and Volpin, there is simply no historical example of a population so financially literate that political campaigns are meaningfully impacted by demands for investor protection except under the most extraordinary of circumstances, typically following a large scandal.

However, Bebchuk and Neeman's minimalist assumption that voters don't matter unless they explicitly vote on investor protection is also questionable. Various works in political science (ex. Rosenbluth and Schaap 2003; Bernhard and Leblang 1999; Quinn and Inclan 1997; Rogowski and Kayser 2002) have noted that democratic governments shape policies that are largely obscure to the voting public in order to generate economic outcomes that increase retrospective economic voting in favor of the incumbent. In this sense, there are political pressures to play to the "public interest" even if the public does not recognize that interest.

The extension to investor protections is clear. Voters may not care about investor protection, but they care about the economy and typically look to capital market performance as an indicator of economic health. Empirical work including Gleisner (1992) and Haynes and Stone (1994, 2004) have demonstrated what political observers have long assumed: higher share prices increase voting for the incumbent. Recent research on Sarbanes-Oxley suggests that investor protection legislation can impact share prices almost instantaneously (ex. Rezaee and Jain 2006, Li, Pincus and Rego 2008). The implication is entirely absent from the literature, but taken up in more detail in the following chapter: the tether that ties government policy to the public interest in investor protection is neither benevolence nor voter recognition of investor protection as a salient issue. Rather, voters' abilities to hold government accountable to their interests is a function of their ability to engage in meaningful retrospective economic voting.

2.5 Summary

Most academic literature on investor protection uses it as an independent variable meant to explain financial development and, in turn, long-run growth trends. Where political economists have attempted to explain investor protection as a variable of interest in and of itself, the leading explanation is that differences in legal heritage drive observable variation, though this approach has been criticized by those who prefer a more political explanation. Most political theories of investor protection view policy as the outcome of a special interest battle between managers, majority and minority shareholders and, often, labor, though the empirical record makes it unclear that labor plays a large or consistent role in setting investor protection policy. Some of the most recent of this literature has suggested that the outcomes of this special interest battle is informed by the way different political institutions impact the sorts of coalitions that can form and the social groups that politicians target in their campaigns. Several more recent works have adopted frameworks that stress the dual importance of special interest lobbying and the public interest, which had otherwise been ignored in political models of investor protection.

These public interest models have the distinct advantage of characterizing office-seeking politicians, rather than interest groups, as the ultimate arbiter of public policy. While these models have produced testable and confirmed hypotheses, they are unable to explain the lingering discrepancies among high income democracies that characterizes the puzzle in this literature.

Chapter 3 – A Common Agency Model of Investor Protection

The theory that I present in this chapter follows closely from a well-known class of principal-agent models termed games of "common agency" (see Galasso 2004 for a survey). The actors in these games include one agent and multiple principles. These games begin with the principles declaring a "contribution schedule" or "menu" that lists the price that the agent is willing to pay the principle in exchange for any action that the principle might take. Each distinct action has its own contribution attached to it (generally, as in my model, without the possibility of negative contributions). The agents derive utility from the payments received from the principals and whatever utility they derive from the action taken. The principals derive utility from the choice the agent makes, minus the costs of their contributions.

In my application, the agents are governments making decisions about corporate governance policy and the principles are lobby groups that are willing to pay for their preferred policies. This approach has been used in many political economy models, notably including Grossman and Helpman's (1994, 1996, 2000) work on trade policy. In Grossman and Helpman's well-known models, lobbying groups use political contributions in the hopes of procuring trade-protection in the form of tariffs and subsidies, and politicians select a policy that maximizes a weighted average of utility derived from the consumer surplus from free trade, as well as from contributions paid by lobbying groups. I describe a scenario in which an incumbent government chooses a corporate governance policy that maximizes a weighted average of utility associaited

with the policy choice's electoral consequences and contributions from corporate insiders and investors, each of whom have their own policy preferences.

In using the common agency framework to model investor protection, my dissertation take a similar approach to other models of investor protection including Bebchuk and Neeman (forthcoming) and, to a lesser extent Perotti and Volpin (2007), who model a single agent (government) and a single principal (insiders). While the choice of modeling frameworks imposes similarities in the hypotheses drawn, I take a significantly different approach to operationalizing the parameters and testing the model. These distinctions are taken up in more fully in section 3.4.

3.1 Formal Model Basics

I denote the level of investor protection as $X \in [0,1]$, with higher values indicating more investor protection. To put this more concretely, consider a Berle-Means corporation – that is, a corporation without a single controlling shareholder - that is run by managers, whose income is derived solely from salary, and owned by shareholders, whose income is derived solely from share price and dividends payments. In this example, all of a firm's income must be allocated to either managerial salaries, dividends payments or reinvestment in productive capital. At low levels of corporate governance, shareholders will have little ability to monitor and potentially sanction managers or directors. In this situation, managers can (and if history is any guide, will) set their salaries at an inefficiently high level at the expense of dividend payments and investment in productive

capital, effectively claiming for themselves an unproductively large share of corporate wealth. Under higher levels of corporate governance, shareholders have greater oversight over earnings allocation within the firm. Rather than over-pay themselves, managers will be more incentivized to allocate firm resources towards a mix of managerial salaries, productive capital and dividends payments that maximizes shareholder value. The above obviously refers to corporate governance policies, but a similar story could be told with respect to securities laws that decrease (or increase) insiders abilities to profit through insider trading, accounting fraud, or a variety of other practices, at the long-term and short-term expense of shareholder value.

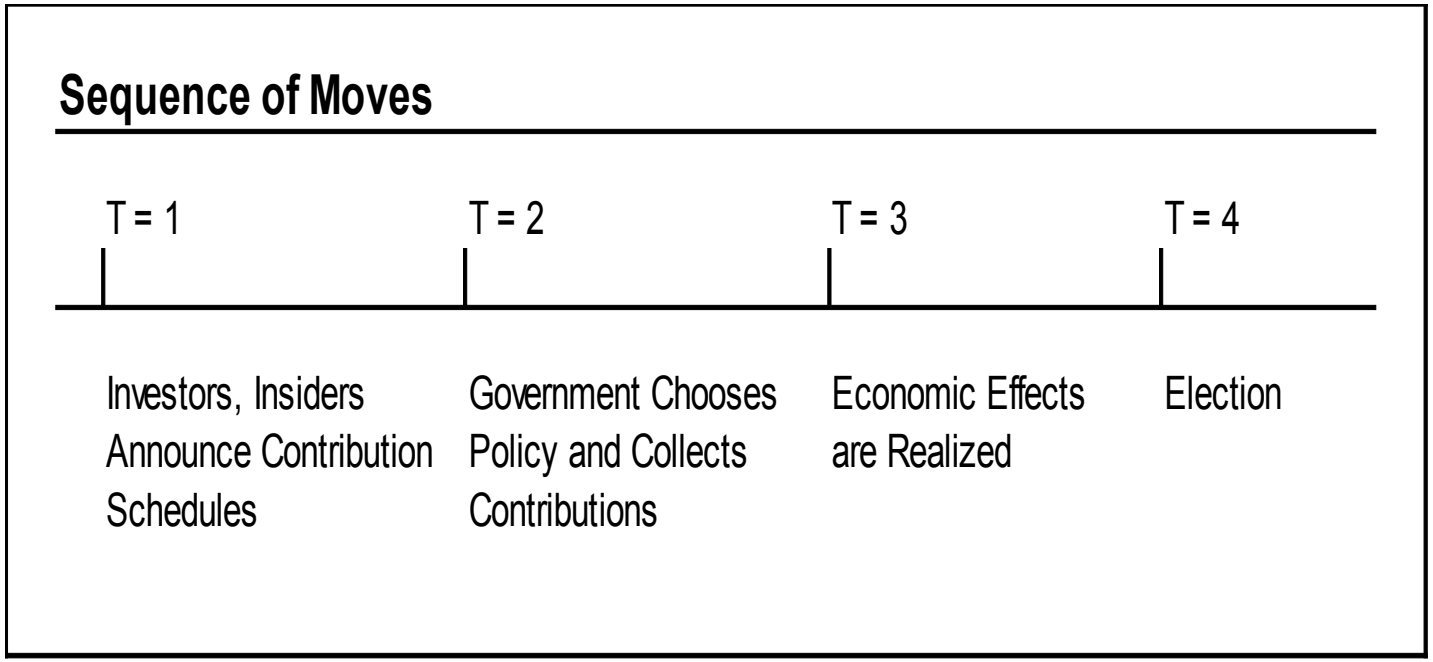
The dynamic in firm with a single controlling shareholder is similar, though managerial salaries is no longer the most obvious source of contention. Instead, imagine a firm that must decide on a contractor to build a new office building. In the absence of a corporate governance regime that empowers minority shareholders, the corporate board is likely to be stacked with directors that are friendly to the interests of the majority shareholder. Indeed, in the absence of cumulative voting or proportional representation or mandates on the number of independent members on the board, it is likely that all of the directors have been explicitly approved by the controlling shareholder. Now imagine that the majority shareholder also owns an over-priced, uncompetitive construction firm. The directors of the firm, whose job security depends on the approval of the majority shareholder, will be likely to choose the majority shareholder's construction firm for the contract, regardless of whether it could get a better deal with another firm. The result is effectively a transfer of wealth from the firm – owned by all shareholders – to just the

controlling shareholder. Now imagine there is a high level of corporate governance, and the corporate board is elected through proportional representation or cumulative voting, and has multiple independent members. Imagine further that independent board members' approval is mandated for related party transactions. In this case, the board of directors is less likely to approve the dubious contract, and minority shareholder wealth is more effectively preserved.

Figure 3.1 shows the sequence of play. In the first stage, insider and shareholder lobbyists declare a contribution schedule – the size of the gift they are willing to give in exchange for any given policy choice made by the government. I denote the gift associated with policy X in insider's and shareholder's contribution schedule as $C_I(X)$ and $C_S(X)$, respectively.

In the second move of the game the government chooses a policy and collects the associated contributions. In the third move the economy reacts to the policy choice. This reaction could take the form of capital flight or capital inflows, increases or decreases in firms' costs of capital, etc. along with the associated impacts on economic growth. In the final move of the game, voters cast their ballots in accordance with perceived changes in their individual welfares. Governments that oversee poorly performing economies are more likely to face public sanction. The core tension faced by politicians is how to balance the the contributions of interest groups against their own electoral interest in the economic welfare of the voting public.

Figure 3.1


Sequence of Moves
T = 1
T = 2
T = 3
T = 4
Investors, Insiders Announce Contribution Schedules
Government Chooses Policy and Collects Contributions
Economic Effects are Realized
Election

3.2 Model

To structure the utility functions I assume that all actors have an ideal level of investor protection – X^G for government, X^I for insiders, and X^S for shareholders – that is the product of their own local knowledge of investor protection's likely impact. I assume that X^G is the policy that maximizes economic performance, which is a function of, among other things, the extent to which the policy promotes capital inflows or capital outflows, which in turn effects the availability and price of capital, share-price movements of currently listed firms and the extent to which markets host IPOs and attract cross-listing from abroad. X^G may or may not be equal to 1, which is to say that I allow for the possibility of overly investor friendly corporate governance regimes that place an onerous financial burden on firms, as well as existing complimentarities in industry that limit the extent to which greater shareholder influence has a beneficial impact on economic outcomes. I assume that X^I is less than or equal to X^G, as insiders have no incentive to lobby for a policy that is gives minority shareholders an inefficiently large amount of power. By the same logic, I assume that X^S is greater than or equal to X^G, as shareholders have no incentive to prefer policies that give insiders an inefficiently large amount of power. The utility functions for politicians, insiders and shareholders are stated as quadratic loss functions and are given below.

$$\text{Governments utility function} = -W_G * \frac{(X - X^G)^2}{2} + C_I(X) + C_S(X) \quad (1)$$

$$\text{Insider's utility function} = -W_I(P_I) * \frac{(X - X^I)^2}{2} - C_I(X) \quad (2)$$

$$\text{Shareholder's utility function} = -W_S(P_S)^* \frac{(X - X^S)^2}{2} - C_S(X) \quad (3)$$

W_G notes the weight governments place on economic outcomes relative to the weight governments place on gifts from lobbyists, which is normalized to 1.[13] W_I and W_S are the weights that insiders and shareholders, respectively, assign to policy, relative to the weight that they assign to the costs of gift giving, which is normalized to one. The P terms connected to the weights capture the the idea that weight that interest groups are willing attach to policy X is proportional to the extent to which that interest group is able to capture the rents associated with that policy. When there is no free-riding - as would be the case if the organized shareholder lobby were the only minority shareholder in an economy, or if organized insiders were the only managers or majority shareholders in an economy - the shareholder lobby is able to capture the entirety of the policy rents accruing to their position within the firm. In this case, the lobby groups could justify spending as much money on lobbying as the the expected utility of the policy is worth.

[13] In keeping with Rogowski and Kayser (2002), Bebchuk and Neeman (forthcoming) and Perotti and Volpin (2004, 2007) I assume that the utility from gifts from lobbyists are unconnected to an incumbent' government's ability to hold office. This assumption has support in the empirical literature. Extant empirical literature consistently finds that campaign spending by the incumbent lacks a meaningful impact on votes (ex. Glantz, Abramowitz and Burkhart 1976; Jacobson 1978, 1980, 1985, 1990; Abramowitz 1991; Levitt 1994; Gerber 2004; and see Green and Krasno 1988 for an alternative finding). Moreover, many political contributions, particularly from business interests, take the form of promises of attractive work on Wall Street or K Street following a retirement from politics, or other in-kind contributions that are not obviously redeemable for votes. Additionally, in practice, one could easily allow reelection odds to be increasing in campaign contributions. As long as contributions have some positive utility outside of reelection, and as long as incumbent governments' reelection prospects are more closely tied to economic outcomes during their tenure than to campaign spending, the results of this model would remain unchanged. However, the cost to parsimony for allowing reelection odds to increase in campaign contributions is significant. Doing so introduces at least two new choice variables. The first of these variables concerns lobbyists' choices over contributing gifts that are useful only to gain votes (buying advertisements, for example), gifts that are not useful at getting votes (such as a promise of a good job post-retirement) or gifts that can be used at a politicians' discretion (cash). Second, one would have to include a choice variable over how an incumbent allocates cash gifts. Analysis of such dynamics, while interesting in their own right, falls outside the purview of this paper.

As free riding increases, the lobby is less able to capture the fruits of their lobbying efforts and the value of policy in their utility function is accordingly lower. A pension that controls 10% of the market can only justify spending 10% of the value of the policy in their lobbying efforts. In practice, this is more of a concern for shareholders, where the costs of lobbying are typically borne on by a relatively small set of institutional investors, while individual investors and passive institutional investors are able to collect the rents.

As noted above, this game is substantially identical to "common agency" games noted in Bernheim and Whinston (1986), Grossman and Helpman (1994, 1996, 2001), Dixit, Grossman and Helpman (1997) and others. As Bernheim and Whinston note, the Nash solution to this type of game allows for infinite equilibria, and therefore requires a more refined solution concept. The solution concept Bernheim and Whinston develop, which has been adopted in the subsequent literature, calls for focusing on "truthful Nash equillbria." A truthful Nash equilibrium obtains when it satisfies the definition of a Nash equilibrium (no player has an incentive to deviate from their prescribed action, given the actions of others) and when principles (in this case: lobbyists) structure their contribution schedule truthfully, so that any positive change in X will be exactly compensated by a change in $C_J(X)$ for $J \in \{I,S\}$. I do not reproduce Bernheim and Whinsten's proofs, but suffice it to note that truthful Nash equilibria exist in the set of best responses for all possible strategies chosen by other interest groups and may, in practice, serve as focal points (Bernstein and Whinston 1986; Grossman and Helpman 1994).

The solution to this game requires both insiders and shareholders to offer contribution schedules that leave the government at least indifferent between accepting

their offer and ignoring it altogether. More formally, lobbyist j solves the following maximization problem.

$$\max (X, C) \quad -W_J(P_J)* \frac{(X - X^J)^2}{2} - C_J(X) \tag{4}$$

$$\text{s.t. } -W_G\frac{(X - X^G)^2}{2} + \sum C_J(X) \geq \frac{W_G(X^* - X^G)^2}{2} + C_{L\neq J}(X) \tag{5}$$

X^* refers to the policy that would obtain if interest group J contributed nothing. In practice, because lobbyists have no incentives to overpay, equation (5) holds in equality. The politician, in turn solves the maximization problem

$$\max (X,C) \; -W_G * \frac{(X - X^G)^2}{2} + \sum C_J(X) \tag{6}$$

which yields the first order condition

$$-W_G(X^G - \dot{X}) + \sum \frac{\partial C_J(X)}{\partial X} = 0 \tag{7}$$

where $\dot{X}$ is the policy chosen in equilibrium. The definition of a truthful Nash equilibrium states that $\partial C_J(X)/\partial X$ is equal to the marginal rate of substitution between policy and money. Thus, we can rewrite equation (7) as

$$W_G (X^G - \dot{X}) + W_I (P_I)(X^I - \dot{X}) + W_S(P_S)(X^S - \dot{X}) = 0 \tag{8}$$

Solving for $\dot{X}$ yields the equilibrium policy choice

$$\dot{X} = \frac{X^G W_G + X^S W_S(P_S) + X^I W_I(P_I)}{W_G + W_I(P_I) + W_S(P_S)} \quad (9)$$

This result makes intuitive sense. As Dixit, Grossman and Helpman (1997) note, equation (9) is effectively weighted averages of each actors policy preferences. To find the full equilibrium solution I refer back to (5) and solve for $C_J(\dot{X})$, which yields

$$C_J(\dot{X}) = \frac{-W_G(X^* - X^G)^2}{2} + \frac{W_G(\dot{X} - X^G)^2}{2} + C_{L\neq J}(X^*) - C_{L\neq J}(\dot{X}) \quad (10)$$

The definition of a truthful Nash equilibrium implies that

$$C_{L\neq J}(X^*) - C_{L\neq J}(\dot{X}) = \frac{-W_{L\neq J}(P_{L\neq J})(X^* - X^{L\neq J})^2}{2} - \frac{W_{L\neq J}(P_{L\neq J})(\dot{X} - X^{L\neq J})^2}{2} \quad (11)$$

Substituting (11) back into (10) yields

$$C_j = \frac{W_G(\dot{X} - X^G)^2}{2} - \frac{W_G(X^* - X^G)^2}{2} + \frac{W_{L\neq J}(P_{L\neq J})(\dot{X} - X^{L\neq J})^2}{2} - \frac{W_{L\neq J}(P_{L\neq J})(X^* - X^{L\neq J})^2}{2} \quad (12)$$

$$\text{where } X^* = \frac{X^G W_G + X^{L\neq J} W_{L\neq J}(P_{L\neq J})}{W_G + W_{L\neq J}(P_{L\neq J})} \quad (13)$$

Thus the full, truthful Nash equilibrium for this model is given by the policy noted by (9), shareholder contributions equal to

$$C_S(\dot{X}) = \frac{W_G(\dot{X} - X^G)^2}{2} - \frac{W_G(X^* - X^G)^2}{2} + \frac{W_I(P_I)(\dot{X} - X^I)^2}{2} - \frac{W_I(P_I)(X^* - X^I)^2}{2} \quad (14)$$

and insider contributions equal to

$$C_I(\dot{X}) = \frac{W_G(\dot{X} - X^G)^2}{2} - \frac{W_G(X^* - X^G)^2}{2} + \frac{W_S(P_S)(\dot{X} - X^S)^2}{2} - \frac{W_S(P_S)(X^* - X^S)^2}{2} \quad (15)$$

3.3 Hypotheses

One could certainly enumerate and test hypotheses relating to all of the parameters included in this model. For the purposes of this dissertation, however, I restrict myself to a focus on the parameters W_G and $W_S(P_S)$.

W_G

The partial derivative of (9) with respect to W_G yields

$$\frac{-X^S W_S(P_S) - X^I W_I(P_I) + X^G (W_I(P_I) + W_S(P_S))}{(W_G + W_I(P_I) + W_S(P_S))^2} \quad (16)$$

which takes on positive values when inequality (17) holds

$$X^G \geq \frac{W_S(P_S)X^S + W_I(P_I)X^I}{W_S(P_S) + W_I(P_I)} \quad (17)$$

(17) simply says that W_G has a positive impact on $\dot{X}$ when the government's ideal point is greater than what would arrived at if policy were merely a weighted average of the ideal points of insiders and shareholders. This condition is most likely to hold if X^G is relatively close to X^S, if $W_I(P_I)$ is large relative to $W_S(P_S)$, or both. Extant works on topic of investor protection that use a similar theoretical framework implicitly assumes that inequality (17) holds, which is to say that the public interest maximizing policy places upwards pressure on $\dot{X}$. In practice (17) rarely fails to hold. None of the international organizations that engage these issues, such of the World Bank or the OECD ever suggest

that investor protections in any country have gotten so strong that capital market performance would be increased by lowering them. I maintain this assumption going forward, though I note that, technically speaking, this need not be the case. This leads to a first testable hypotheses

H1: Investor protections will be higher when government places more weight on corporate governance policy.

When does corporate governance have a greater impact on governments' abilities to retain office? Perotti and Volpin (2004, 2007) argue that the key distinction is between democracies, whose governments are accountable to the public interest in investor protection, and autocracies, whose governments are not. However, while democracy is obviously a key determinant of public accountability, it cannot explain the variation among established democracies that is captured in Figure 1.1 and motivates this dissertation. If the key factor tying governments to the public interest in investor protection is the public's ability to engage in retrospective economic voting, two conditions must hold if investor protection is to have a meaningful impact on a democratic governments' reelection prospects: (1) governments' tenure security must be sensitive to shifts in vote share, and (2) investor protection must have a meaningful impact on economic voting. In that light, I locate domestic and international factors that inform the value of W_G.

On the first point, that government's tenure security must be sensitive to shifts in vote share Rogowski and Kayser (2002) demonstrate that electoral rules help determine

the impact of marginal swings in votes on retaining office. Swings in vote share have a larger impact on the resulting seat share under majoritarian electoral rules than they do under more proportional electoral rules. When the preferences of a money-contributing special interest group are opposed to the preferences of the vote-contributing public, Rogowski and Kayser argue that governments elected under majoritarian electoral rules will weigh the contributions of the public (votes) more highly than their counterparts that are elected under proportional electoral laws. Rogowski and Kayser use this theoretical expectation to explain why countries using proportional electoral laws have higher consumer prices than countries with majoritarian electoral rules. Scartascini (2002) similarly argues that governments in proportional electoral systems favor the interests of incumbent firms over the public by erecting more barriers to starting a company that are present in majoritarian systems.[14]

While sensitivity to economic voting is a primary concern in characterizing the politics of investor protection, it does not address a logically prior question: When does investor protection matter to the economy, and, by extension, economic voting? A large body of work in political science and economics suggest that when high levels of investor protection are available on similar stock markets, failing to protect investor rights dampens inward capital flows from internationally mobile capital (Aggarwal, Klapper

[14] Importantly, both of these cases the issue at hand is both important and anonymous, allowing its politics to be approximated by a government trade-off between the money contributed by the few against the possibility of economic voting by the public in the future. In contrast, Rogowski (1987) and others have argued that when an issue is sufficiently salient that there are legislative districts dominated by voters who will vote specifically on this issue, the smaller districts typical of majoritarian electoral rules can allow concentrated special interests to more easily capture the policy making process. Culpepper (forthcoming) notes, however, that the defining characteristic of investor protection is its low salience to voters, and even to many interest groups. For that reason, I expect the politics of investor protection to conform more to Rogowski and Kayser than to Rogowski.

and Wysocki 2005, Hebb and Wojcik 2004). The ability of the London based SEAQ-I's superior trading environment to sap continental exchanges of much of their liquidity - 50% of trading on Paris markets, 33% of trading on German markets - demonstrates how powerful international competition can be in this regard (Ramos 2003).

Importantly, these pressures are not evenly distributed across space or time. Despite the increased interconnectedness of global financial markets, there have been and remain significant transaction costs to foreign investment. In practice there remains a strong bias for investing in familiar markets. Lane and Milesi-Ferretti (2008), Portes and Rey (1995), Tesar and Werner (1995), Hau (2001) and others have noted that investors tend to invest in markets that are geographically proximate and linguistically similar to their own. This "home bias" is also evident in domestically held portfolios, which tend to cluster geographically around the home base of the fund (Coval and Moskowitz 1999, Grinblatt and Keloharju 1999). By implication, states in the same region, which are likely to share many such characteristics, will often compete for the same capital. As such, I expect that the adoption investor protections in neighboring states is particularly important for domestic lawmakers. They must adopt comparable regulations or else lose out on capital flows into neighboring states.

A second source of competition comes from countries at similar development levels. Internationally mobile investors typically distribute their capital across developed and emerging markets to increase returns and lower risk by choosing investments whose returns are relatively uncorrelated (ex. Errunza and Pabmanabhan 1988; Harvey 1993). This is particularly true of large institutional investors that often place a premium on

having a voice as shareholders. By failing to protect investor rights, states lose out on capital inflows to markets that offer investors a similar opportunity to diversify away portfolio risk. Therefore, differences in the corporate governance regimes of two similarly developed countries - Brazil and Malaysia, for example - ought to have a greater impact on each state's ability to attract investment capital than differences in corporate governance regimes from dissimilarly developed countries, such as Brazil and the United Kingdom. I suspect that the extent of investor protection in countries with similar levels of development is a good indicator of the extent to which countries face competitive pressures to attract capital by protecting shareholders from rent seeking.

In light of these operationalizations, I can restate hypothesis 1 in a more testable form:

H1a: Countries using more proportional electoral laws will have lower levels of investor protection

H1b: Countries whose regional peers have high levels of investor protection will also have high levels of investor protection

H1c: Countries whose development level peers have high levels of investor protection will also have high levels of investor protection

An Extension to Insider Trading

In the empirical chapter that follows I will examine several measures of $\dot{X}$, including the adoption and enforcement of insider trading laws. The binary nature of insider trading laws poses one complication that differentiates it from continuous, or near-continuous

measures of investor protection. For any given electoral rule, I expect that increased competition on capital markets will increase the level of observed investor protection. Likewise, for any given level of competitive pressure I expect that more majoritarian electoral rules will increase the level of investor protection. This is to say that, in tests aimed at a continuous measure of investor protection, I would not expect an interaction between international competition and domestic politics. However, the adoption and initial enforcement of insider trading laws are binary concepts. Thus, what I observe is whether or not W_G gets above a discrete threshold, regardless of whether W_G is primarily a function of international or domestic pressures. To put this more concretely, I expect that the impact of electoral law will diminish when international competition is fierce, because governments running for reelection under all sorts of electoral rules will feel sufficient pressure to adopt and enforce insider trading laws. Likewise I expect that the influence of international competition will diminish when governments are seeking office under relatively majoritarian electoral laws, where slight competition will be enough to sway government to ban insider trading. This leads to another testable hypothesis.

H1d: The impact of electoral law on the adoption and enforcement of insider trading laws will reduce when a country's regional and/or development level peers have banned insider trading.

H1e: The impact of competitive pressures from regional and development level peers will reduce in countries whose governments are elected under relatively majoritarian electoral laws.

$W_S(P_S)$

Taking the first derivative of (9) with respect to $W_S(P_S)$ yields

$$\frac{W_S(P_S)(X^S - X^G) + W_I(P_I)(X^S - X^I)}{(W_G + W_I(P_I) + W_S(P_S))^2} \quad (18)$$

Because $X^S \geq X^G \geq X^I$ by definition, inequality (18) is always positive. This leads to a second set of hypotheses.

H2: Investor protections will be higher when organized shareholders place a greater weight on policies

Why might some shareholders care more about the returns from corporate governance than others? Insurance companies and mutual funds care about the returns on their investment, but commercial conflicts of interest have kept almost all of them from aggressively promoting shareholders' rights. Hedge funds often collect a large performance fee (the standard charge is 2 and 20, i.e. 2% of capital, 20% of profits), and their ability to earn high returns is a key focus of their marketing efforts. Hedge funds have been quite engaged in firm level corporate governance activism, though there is no evidence that this has spilled over into policy action.

The motivations facing pension funds are considerably more complex. Taking up the mantle of shareholder rights at the policy level means that the returns on lobbying will be spread across the market. The key concern for pension funds is whether or not they compete with other pension funds for clients on the basis of returns. Some pension funds do not compete for the same pool of clients. Public employees in California do not have the option of enrolling in the New York City Retirement System, and vice versa. The *relative* rate of returns of the two funds makes little difference. Money is not

necessarily wasted if CalPERS' lobbying increases the rate of return on NYCERS' investment portfolio. Other pension funds do compete on the basis of relative returns. In a mandatory pension systems in which workers choose from a list of licensed fund administrators, what matters most is how a fund performs relative to other options. If one pension fund's lobbying efforts equally helps another's returns and their ability to attract clients, that money is wasted. To the extent that pension funds control similarly allocated portfolios, the same logic should apply to activism at the firm level. Thus, I can restate hypothesis 2 in more concrete terms.

H2a: Investor protection will be higher when pension funds have a financial motivation in absolute returns rather than relative returns

A second hypothesis that relates to $W_S(P_S)$ is:

H3: Corporate governance will be higher when organized shareholders face fewer free riding problems

Even if a pension fund is otherwise incentivized to care about corporate governance policy, their willingness to do anything about it is constrained by free riding. Many individual funds are small and have accordingly small equity positions. Given the startup costs to lobbying – hiring lawyers, doing research, etc - the returns on lobbying will often not be enough to sustain any meaningful effort. Free riding has occasionally been overcome through pension funds forming industry wide lobby groups that are active on some of the more pressing corporate governance issues. Free riding can also be

overcome internally, by having a large enough stake in the stock market that the returns on lobbying are justified even if no other fund contributes.

H3a: Investor protection will be higher if pension funds are able to overcome barriers collective action through cooperation, or by being large enough to justify actions by individual pension funds

3.4 Summary

Why do some governments protect minority shareholders from excessive rent seeking by corporate insiders while others do not? Chapter 3 suggests that policy outcomes governments reflect trade-offs that governments make between the contributions of interest groups representing shareholders and corporate insiders and their own electoral interest. My theory therefore expects that minority shareholders will be better protected from insider rent seeking when the shareholder lobby is strong relative to insider lobbies and when governments are more responsive to the economic consequences of corporate governance policy. I assume, for simplicity, though I think it is an accurate assumption, that corporate insiders are powerful everywhere, and that the main point of variation is the extent to which a shareholder lobby can form, and the extent to which government is responsive to the public interest in corporate governance.

I have argued that four factors contribute to these conditions: 1) international competition, which determines the extent to which there is a public interest in the protection of minority shareholders; 2) domestic electoral laws, which shape government responsiveness to this public interest; 3) the existence of pension funds that can overcome free-riding induced barriers to collective action, either externally or internally, by simply

being large; and 4) the extent to which pension funds are motivated by their stock returns in real terms or relative to other pension funds that compete for subscribers.

Chapters 4, 5 and 6 test these hypotheses through large N, cross-national quantitative tests, large N cross-US-state quantitative tests and a largely qualitative examination of the Polish pension system, respectively. Not every test examines every hypothesis, for reasons of measurement problems, and because some concepts are irrelevant for some contexts (there is no corollary for electoral rule variation across US-States, for example). Together, however, they paint a clear picture of the validity of the aforementioned hypotheses.

Chapter 4 Insider Trading Laws and Shareholder Voting Rights

In this chapter I present a series of large-N statistical analyses that tests my hypotheses. I use three different dependent variables: shareholder voting rights, the adoption of insider trading laws and the enforcement of insider trading laws. I begin with shareholder voting rights.

4.1 Shareholder Voting Rights

Shareholder voting rights have been the primary indicator of investor protection in the quantitative literature. These data refer to the ease and efficacy with which shareholders can voice their preferences through the shareholder meeting. Shareholder meetings are organized gatherings in which shareholders can receive information about a companies business situation and vote on proposals that have been suggested by the board of directors, managers or shareholders. Shareholders meetings are typically held once a year at an annual general meeting (AGM), though pressing matters, such as the issuance of new equity, consideration of takeover bids, or mid-year reorganization of the corporate board may warrant calling an extraordinary general meeting (EGM). When shareholders have voting rights that amplify their power within the firm, they are better able to act as a check on managerial self-dealing. Many papers, most notably La Porta et al. (1997 1998), have demonstrated that these indicators correlate with better capital market performance.

The dependent variable used most commonly to capture the extent of shareholder voting rights comes from La Porta et al.'s (1998) dataset. This variable draws on survey responses by market professionals in 47 countries and notes, in a single, cumulative index the presence or absence of six key shareholder voting rights in 1997. These six rights include (1) whether proxy voting by mail is allowed; (2) whether shares are not blocked before a shareholder meeting, (3) whether cumulative voting for directors is allowed, (4) whether oppressed minorities are protected, (5) whether the share capital required to call an extraordinary shareholder meeting is less than 10 percent, and (6) whether shareholders have pre-emptive rights at new equity offerings. Higher values on the shareholder rights index denote higher corporate governance standards. Before moving on, it is worth explaining each constituent part of La Porta el al.'s index.

Proxy Voting By Mail

Proxy voting by mail refers to the allowable methods of voting in a shareholder's meeting. In practice, only a small percentage of shareholders typically attend shareholders meetings. There are a variety of reasons for this. First, most shareholders hold only a small part of their portfolio in any given firm, and it is often not worth the effort or expense for small shareholders to attend shareholders meetings. Complicating matters, shareholders meetings are often held in out of the way locations. The retailer Target held its 2009 AGM in Waukesha, WI., Walmart's AGM is held, naturally, in Bentonville, AR. Some firms, particularly in emerging markets, have been known to

intentionally schedule AGMs in out of the way locations on inconvenient dates (New Years Eve, for example) as a way of suppressing shareholder turnout.

Even if a shareholder wishes to attend a meeting, most firms hold their annual meetings at roughly the same time, during so called “proxy seasons”, which vary from country to country. In the US proxy season is in the spring, with a smaller round of meetings in the fall. A shareholder cannot be physically present in more than one meeting at once, and so the holders of diversified portfolios are limited in their ability to vote directly in all of the relevant meetings.[15] The inability or unwillingness of minority shareholders to exercise their voting rights effectively increases the power of management and/or founding families or other large blockholders. Without a remedy, corporate insiders can exercise control over a firm despite not having a controlling share of the firm's equity.

The way around this is so called “proxy voting”, wherein individual shareholders can authorize another party to vote on their behalf (typically management or an institutional investor with a large stake in a firm) or exercise their own vote through mail. The proxy by mail component of La Porta et al..'s index of shareholder rights includes a sub-variable that is coded 1 if a country's laws mandate that firms allow proxy voting through the mail. More recently many firm have allowed proxy voting through the internet. 2008 EC rules require member states to allow proxy voting by internet. Delaware law currently allows corporate boards to replace a physical AGM with one that is held entirely online. As such, the proxy-by-mail component of the La Porta et al. index

[15] For institutional investors this is obviated somewhat as more than one representative can be authorized to vote the institution's shares.

is bit outdated, but is nonetheless a relevant indicator of legal rights for shareholders through the 1990s and early 2000s.

Share Blocking

Share blocking is a process in which shareholders deposit their shares at a bank or other financial institution for a set period of time before and after a shareholders meeting in order to be eligible to vote. The ostensible rationale for share blocking is to verify that voting shareholders are, indeed, shareholders at the time of the vote. However, share blocking's primary effect is to limit the participation of shareholders by adding an obstacle. This is particularly relevant for institutional investors, who typically find the rewards from voting not worth the financial risk of temporarily immobilizing part of their portfolio (European Commission 2006). A ban on share-blocking increases the value of the index by 1 point.

Cumulative Voting

Cumulative voting refers to the all important process through which nominated directors are elected to the corporate board. Cumulative voting gives shareholders an amount of votes equal to the number of voting shares held multiplied by the number of officers up for election, and allows shareholders to allocate their votes however they want, including casting all of their votes for a single candidate for the corporate board. The alternative is

called “statutory voting” in which shareholders receive a number of votes equal to the number of shares they hold to be used in separate elections for each board seat. To take an example, suppose a minority shareholder held 10 shares and there are 5 members up for election. Under statutory rules that shareholder could vote 10 times for each of the 5 seats up for reelection. If another shareholder holds 20 shares and supports a different candidate, they could effectively undermine any ability of the smaller shareholder to elect candidates of their choosing. Under cumulative voting the shareholder could, if he or she wanted, allocate all 50 of their votes to a single candidate. This possibility allows minority shareholders to magnify their influence on the composition of corporate board by focusing their efforts on fewer candidates.

Cumulative voting is particularly important in firms with a single controlling shareholder. Under statutory voting, if a single voting entity controls 51% of the votes, they will be able to stock the corporate board with directors friendly to their own interest. Cumulative voting allows minority shareholders to help ensure that at least some board members will be independent of insider influence. Of course, the cumulative voting measure sidestep the issue of proxy access, which is the method through which shareholders can place their own nominees onto the corporate ballot. These laws vary across countries, but are not coded as part of this measure. La Porta et al.'s measure is increased by 1 if a country's laws allow for cumulative voting.

< 10% Share Capital Required To Call An EGM

As noted earlier, EGMs may be called to consider an urgent proposal whose consideration cannot wait until the next AGM. Examples typically include consideration of mergers or acquisitions, large new equity issues or the dismissal of a management executive or board member. Typically the board of directors or large shareholders can call extraordinary meetings. The question is how large a shareholder has to be to call such a meeting. The larger the requirement, the less capable are minority shareholders of placing their concerns before a shareholders meeting except during an annual meeting.[16] La Porta et al.'s index is increased by 1 if a country mandates that a 10% stake is sufficient to call an extraordinary shareholders meeting.

Preemptive Rights To New Equity Offerings

Preemptive rights to new equity issues – usually referred to simply as "preemptive rights" - gives existing minority shareholders a measure of protection from dilutive equity issues. Dilutive equity issues causes two set of problems for minority shareholders. The first occurs when when a firm issues shares at below market value to corporate insiders or related parties. This practice is effectively a transfer of wealth from outside shareholders, whose shares are depressed in value by the new issues without offsetting revenue accruing to the firm. In one particularly egregious case in the United States, a majority shareholder at James Martin Associates proposed issuing 500,000 shares of new equity at $1 a share to insiders, effectively lowering the price of shares held by outsider from $90

[16] The minimum number of shares required to make a proposal at an AGM is another issue, though not one that is addressed in La Porta et al..

to $1.78 (O'Neal and Thompson 2004, cited in Atansov et al. 2007). The second impact of dilutive equity issues is that, even when issued a market prices, it can redraw voting power within the firm. Thus dilutive equity issues, similar to poison pills, can be used by management or controlling shareholders to decrease the influence of minority shareholders. Preemptive rights to new equity issues ensures that existing shareholders will have a preemptive right to purchase any new equity issues in equal proportion to the shares already held (in practice, most such laws exempt equity issues that are very small (Atansov et al. 2007)). As such, preemptive rights allow outside shareholders to protect their voting power and asset value. La Porta et al.'s variable is increased by 1 when extant shareholders have a preemptive right to new issues.[17]

Oppressed Minorities

Whether or not oppressed minorities are protected refers to two policies. The first is whether minority shareholders have legal standing to sue firm directors if they have not been granted the rights due to them as minority shareholders. The second is whether or not minority shareholders have the right to demand a stock buy-back if such rights are not granted. The La Porta et al. variable index is increased by 1 if shareholders are given recourse through legal standing or the ability to demand a share buy-back.

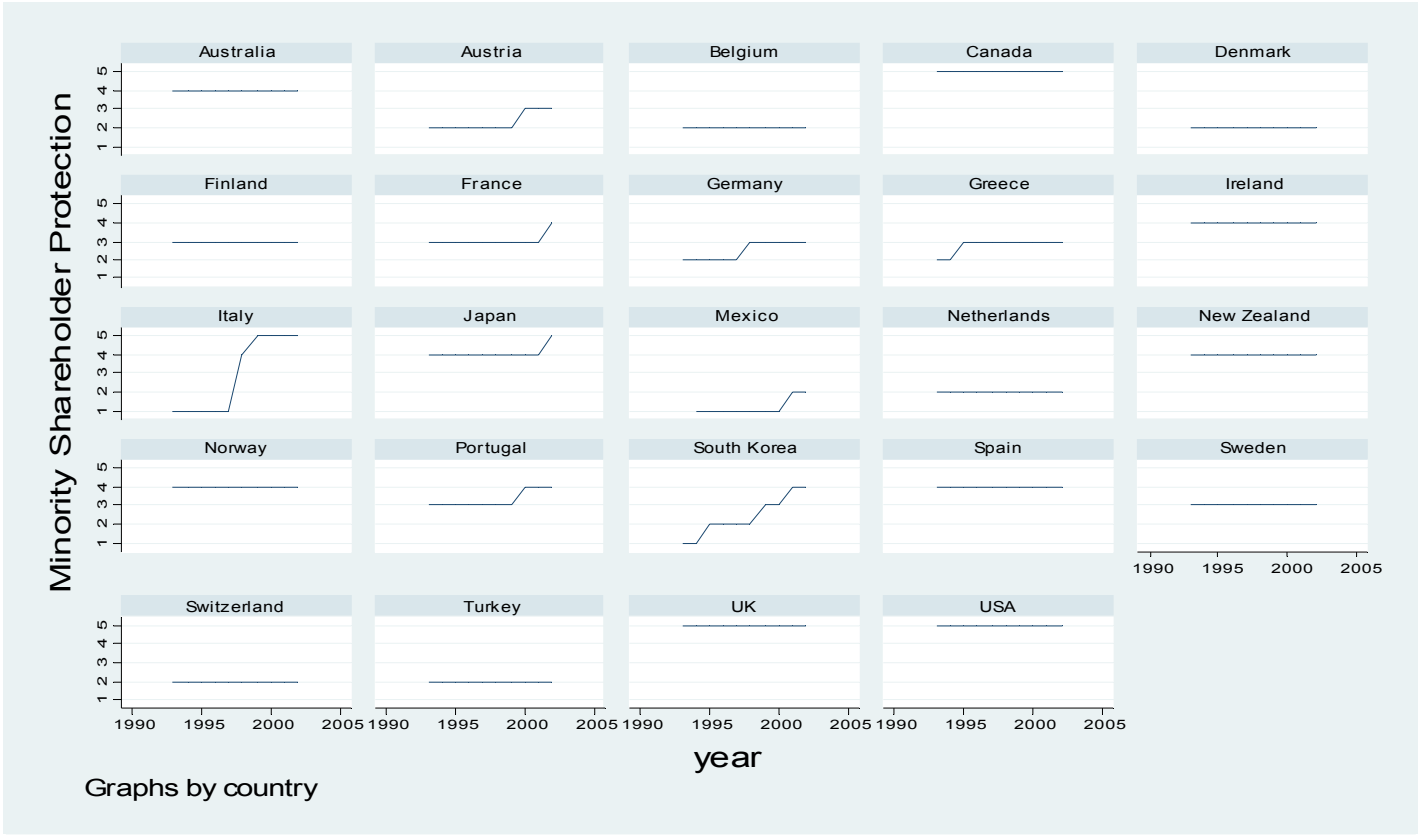
Despite its prominence is the literature, the La Porta et al. variable poses significant

[17] Spamann (2006) notes that approval rights, rather than preemptive rights are a functional equivalent, though these are ignored in La Porta et al.'s codings.

problems. First, this measure is cross sectional, capturing a snapshot of corporate governance policy in 1997. This can be problematic for theories that focus on political institutions or economic factors (as opposed to legal heritage, which was the focus of La Porta et al.'s study). The conditions at the date of observation may not be the same as those in place when the policies were set. Electoral institutions, the special interest landscape and the competitive environment that governments face often change. Bebchuk and Roe (1999) have noted strong theoretical reasons for the considerable path dependence observed in the data, which further obscures the link between a cross-sectional snapshot of policy and the political economic factors that give way to its rise. To take an example, Italy scores a 1 out of 5 in La Porta et al.'s dataset. The Borsa Italiana was founded in 1808. Since then Italy has been governed as a collection of city states, as a monarchy, as a fascist dictatorship, as a democracy using proportional electoral laws and as a democracy using majoritarian electoral laws. There is no way of knowing from this dataset which of these governments enacted the laws that lead Italy to score a 1 out of 5. In short, La Porta et al.'s data is ill-suited to the demands of my theory.

As an alternative to cross sectional measures, Pagano and Volpin (2005) extend La Porta et al.'s measure to include years from 1993 through 2002. This is clearly an improvement, though similar problems remain. While there is some variation within cross sections, most countries in the sample never change their values. To show the extent of cross-national vs within panel variation, Figure 4.1 shows Pagano and Volpin's variable for OECD countries. With the exceptions of South Korea and Italy, the changes that are observed over this period are minor, moving by one at most, and not moving at

Figure 4.1


Minority Shareholder Protection
1 2 3 4 5
Australia
Austria
Belgium
Canada
Denmark
Finland
France
Germany
Greece
Ireland
Italy
Japan
Mexico
Netherlands
New Zealand
Norway
Portugal
South Korea
Spain
Sweden
Switzerland
Turkey
UK
USA
1990 1995 2000 2005
year
Graphs by country

all for most countries. Thus, despite the time series aspect of the data, much of the variation is across, rather than within panels. As such, most of the observed variation is attributable to policy decisions made before the observation period, in a political economic context that may be quite different than the one observed in the data.

Beyond these methodological shortcomings, there are other, more substantive, reasons to be skeptical about Pagano and Volpin's or other similar measures. First, this variable as coded as a single measure per country year, yet in some countries the nature of corporate law defies such coding. In the United States, for example, there is no national policy on the issues included in the index because corporate governance policy is made at the state level. The codings are therefore meant to reflect the law in Delaware, where over half of American companies are domiciled, but the laws in other states vary considerably. The United States is not the only country that poses this sort of problem. The Japanese commercial code allows firms to opt into an Anglo-American style of corporate governance or a more traditional (and less shareholder friendly) Japanese legal form. Germany and Brazil (among others) have experimented with alternative stock markets (the *Neuer Markt* and *Novo Mercado*, respectively) whose rules require more shareholder-friendly corporate governance policies than those imposed on public corporations in general. Single national indicators of corporate governance can be misleading.

Second, this variable, as with the variable noted in Table 1.1, is a purely *de facto* measure. It only captures laws on the books, and is silent to the possibility of divergence

between the laws on the books and the conditions faced by shareholders in the shareholders meeting or in the court system if they seek redress.

Third, the importance of shareholder voting rights varies across countries with different ownership configurations. A country populated by firms with majority shareholders is far different than a country with diffuse ownership. Neither share blocking, proxy by mail, nor the ability to call an EGM are particularly meaningful when a single controlling shareholder can determine any and all voting outcomes. Other components are more applicable across countries with different patterns of ownership, including cumulative voting and protection against dilutive share issues. However, this disaggregated data is unavailable in panel data format, making it subject to the same problems as La Porta et al..'s dataset. Moreover, data on ownership concentration in a country's firms is elusive, endogenous to the policy environment and typically misleading in countries where pyramidal ownership structures warp the relationship between share ownership and voting power.

Despite the above noted limitations, shareholder voting rights are a key indicator of corporate governance, and the primary indicator used in the extant literature. As such, my first set of empirical tests subjects my hypotheses to test using Pagano and Volpin's variable noted above.

4.1.1 Sample

The universe of countries for which the dependent variable is coded includes all OECD countries except Poland, Czech Republic, Hungary, Slovakia and Luxembourg, and a variety of non-OECD countries including Pakistan, Nigeria, Zimbabwe, Malaysia, India, Egypt, Thailand and others. I restrict my sample to include only OECD countries. I exclude non-OECD countries for two main reasons. First, this variable lacks any information about the enforcement of these laws, which is notoriously non-existent in countries that lack a sufficiently sophisticated and uncorrupted judiciary. Much of the international legal architecture surrounding foreign direct investment, for example, is aimed at allowing foreign investors to avoid subjecting themselves to the often capricious court systems in developing countries (Kerner 2009). Even within the United States, the decision to incorporate in Delaware is commonly based on the reputation that state's judiciary's ability to handle complex corporate cases. In the absence of a reliably coded indicator to this effect, I am far more confident in the efficacy of corporate law in OECD countries than in non-OECD countries.

A second reason is that the sample of non-OECD countries included in the original codings is decidedly non-random. Roughly half of all non-OECD countries coded by the dependent variable have history of British colonization, vs roughly 15% of non-OECD countries that are not coded but nonetheless have stock markets. Focusing on just OECD cases avoids this non-random selection bias. Focusing on OECD countries also restricts my sample to country-years that are democratic enough that my measures of electoral law are meaningful indicators of the political process.

This results in a country-year dataset of 23 countries measured over 10 years, from 1993 to 2002. The sample is relatively balanced, with the lone exception being Turkey, on which there is some missing data. I include data from the Republic of Korea for the entire observation period, despite the fact that they only entered the OECD in 1996.

4.1.2 Method

I estimate my models in their panel data format, as well as in a cross sectional format by taking panel averages over the years in question. I estimate models using two different panel estimators: a pooled ordered probit estimator with robust standard errors clustered by country and a random effects linear model, again with robust standards errors clustered by countries. The pooled ordered probit accounts for the ordinal construction of my dependent variable. While a panel estimator would be preferred, Wooldridge (2004) notes that the random effect and fixed effect ordered probit (and logit) models are heavily biased, and the pooled model is a preferable alternative. As an alternative estimator I use a linear panel estimator that, while not accounting for the ordinal nature of the variable, does a better job of addressing the panel nature of the data. The results of a Hausman test indicate that the unit fixed effects, which are almost certainly present in the data, are well captured by my independent variables and the random effects model does not show signs of inconsistency. I therefore opt for the more efficient random effects estimator. In the cross sectional models I use an OLS estimator with robust standard errors. When taking the panel average, the 5-point ordinal dependent variable takes on 17 categories, making

the OLS estimator a reasonable fit to the data.

4.1.3 Independent Variables

Proportionality

I rely on a measure of district magnitude to capture proportionality. Using this measure has at least two advantages over the dichotomous proportional vs majoritarian indicator variable used by Rogowski and Kayser (2002) and the trichotomous measure used in Pagano and Volpin (2005). First, district magnitude allows me to capture the considerable variation that exists among proportional systems. For example, many countries have a district magnitude of 2, indicating a modestly proportional electoral system. The Netherlands, which pools candidates in a single, national district has a district magnitude of 150. Likewise, the Israeli Knesset pools across a single national district, resulting in a district magnitude of 120. These are meaningful differences that would be lost using a dichotomous or trichotomous measure.

There are two sources of district magnitude that I am aware of in publicly available datasets. The first comes from the Database of Political Institutions (henceforth: DPI) compiled by Beck, Keefer and Clark (2001). This database spans a wide cross-section of countries from 1975 through 2006 and records, along with many other variables, the average district magnitude. An alternative variable comes for Golder's (2005) Democratic Electoral Systems Around the World, 1946-2000, which notes average and median district magnitude for a wide cross-section of countries from

1946 through 2000. When there is overlap, these measures correlate very closely. While I prefer to use Golder's measure of median district magnitude on grounds of construct validity, my primary concern is temporal coverage. Using the Golder measure would necessitate truncating 2 (out of 10) years of data. I therefore use the DPI measure.

Competitive Pressures

I use two measures to capture the extent of competitive pressures, one to capture competition stemming from geographic neighbors, and the other to capture competition from countries at similar development levels. *Regional Diffusion* is meant to proxy for cultural, linguistic, and other similarities that are typically geographically correlated. As noted above, cultural, linguistic and geographic proximity all reduce informational asymmetries, with the effect that portfolio managers tend to cluster their assets in similar countries. As such, countries that share similarities in culture, language and geography will effectively be competing with one another for investment capital. To the extent that geographic proximity also captures industrial similarities and similar growth opportunities that make investments in neighboring countries interchangeable, *Regional Diffusion* should capture that element of competitive pressure as well.

I construct *Regional Diffusion* by taking the average value of the dependent variable across every country in the region, other than the country in question, for each year. I separate the world into 6 regions using the correlates of war codings: North America and the Caribbean, Latin America (including Mexico), Western Europe, Eastern Europe, Africa and the Middle East, and Asia and Oceania (Several of these regions have

no OECD countries, and are thus irrelevant to this sample. The full coding is more relevant for my models of insider trading laws). When this variable takes on high values, there should be greater incentive for governments seeking investment to offer corporate governance regimes that are at least as good as their regional competitors, for fear of losing extant investment and failing to attract new investment. Conversely, when the regional norm is low levels of corporate governance, I suspect that investment-seeking governments will face relatively less pressure (though certainly not no pressure) to offer investor-friendly corporate governance laws. Using this coding, rather than simply weighting by distance, gives a more accurate view of capital market competition. I don't think, for example, that North Africa being much closer to Europe than it is to Latin America is meaningful in this context. Using a measure that is simply weighted by distance, even one that is logged, or otherwise discounts differences in large numbers, would necessarily pick up much of that information.[18]

To construct the variable that I call *Development Level Diffusion* I calculate the absolute value of the difference in the log of GDP per capita for every dyad of countries that operate stock exchanges (not just those included in my sample). For each country-year, I then calculate the average level of shareholder voting rights whose GDP per capita is similar enough that the absolute value of the difference of logged GDPs per capita is less than or equal to .3.[19] For the most part, this produces intuitive pairings. Calculating South Korea's value in 2002 uses information from New Zealand, Greece, Portugal and Spain. Turkey's score in 2002 includes data from Brazil, South Africa and Thailand.

[18] In practice I get similar results using a "weighted by distance" coding scheme.

[19] Using a cutoff of .3 is arbitrary, and was selected because it created reasonable pairings for most country-years I examined. In practice, using different cutoffs produces similar results.

Norway's score in 2002 includes data from Japan, USA, Switzerland and Denmark. As per my hypotheses I expect that countries whose development level peers have strong shareholder voting rights should be pressured to have strong shareholder voting rights themselves.

Pension Funds

My hypotheses suggest two important factors for pension funds: the extent to which they compete for subscribers and their ability to overcome free riding. I know of no data that would allow me to code for the former concept, and so I do not attempt to test it here. The latter concept is also troublesome, as there is no data on the extent of pension fund organizations or even whether a country's pension fund industry is dominated by many very small pension funds or fewer larger ones. However, simply having pension funds with substantial financial holdings is a minimum condition for overcoming free riding problems, and I can test for that, though somewhat circuitously. The OECD keeps data on the size of pension fund assets, with substantial, but manageable amounts of missing data. However, even if total pension holdings is a good proxy for equity holdings, what data is available is deeply endogenous. Higher levels of corporate governance increases savers' willingness to invest, and likely induces them to increase contributions to their own pension funds. It may therefore be that higher levels of corporate governance lead to larger equity holdings, and not the other way around.

To get around this I rely on a proxy variable taken from Perotti and

Schwienbacher (2008). Perotti and Schwienbacher argue that the financial holdings of pension funds (and insurance companies) is closely linked to that country's experience with hyper inflation - which they define as a annual increase in the CPI of over 400% - prior to the establishment of the national pension system. Inflation destroys financial assets, and in the wake of the hyper-inflation that swept through much of the world following WWI and again following WWII, the financial assets of the middle classes were wiped out. Perotti and Schwienbacher argue that this steeled populations and their political representatives against reliance on capital markets and in favor of retirement systems that relied on pay-go mechanisms funded by the seemingly more stable ability of governments to meet their fiscal obligations. As a result, a pattern emerged wherein pension funds with large financial holdings are clustered in countries that did not experience hyper-inflation and vise-versa. Specifically, their findings suggest that the impact of experiencing a spell of hyper inflation reduces funded pension and insurance assets from roughly 30%-50%, depending on the specification. I construct a dummy variable *Hyper Inflation* coded as 1 for countries that experienced an annual change in their CPI of over 400% prior to the establishment of a national pension system and 0 otherwise.[20]

While reliably exogenous – corporate governance policy in the 1990s surely did not impact inflation 50 years earlier - this proxy variable approach has significant limitations. First, many pension assets that are invested in capital markets are in assets other than stock. Data on the actual stock holdings of pension funds is elusive. The

[20] The countries that experienced such a shock are: Austria, Germany, Greece, Italy, South Korea and Mexico.

OECD's dataset on equity holdings is comprised almost entirely of missing data, precluding an instrumental variables approach. Moreover, this variable says nothing about how pension funds are organized. The Netherlands, for example, has a small number of very large pension funds, while other countries have more, smaller pension funds. *Hyper Inflation* only captures the extent to which these funds are likely to hold corporate equity in their portfolios, a necessary, but insufficient condition for overcoming free riding.

A final potential shortcoming is that Perotti and Von Thadden (2006) have argued that the same hyper inflationary periods that led citizens to prefer pensions that are unconnected to capital markets also led them to support low levels of investor protection. For reasons noted in the literature review, I find this argument unconvincing. Given that private citizens almost never demand anything related to corporate governance, but pension funds often do, a more plausible mechanism would look like this:

Low Inflation ---> Growth Of Pension Funds ---> Demands For High Corporate Governance By Pension Funds

rather than this:

Low Inflation ---> More Individual Investors ---> Demands From The Public For High Corporate Governance

For these reasons, any conclusion drawn from these tests related to pension funds are

suggestive, at best, and *do not* provide a meaningful test of hypothesis 3a. I reserve such analysis for chapters 5 and 6.

Control Variables

Beyond my key independent variables I include several control variables to guard against spurious results. To control for La Porta et al.'s legal heritage theory, I include a dichotomously coded variable coded 1 if a country uses common law (*Common Law*) and 0 otherwise. Based on their findings that countries in the British legal tradition have higher corporate governance standards, I expect the coefficient on *Common Law* to be positive. Moreover, common law and majoritarian legal institutions have a common antecedent in British colonial rule. As such, it is important to ensure that my results concerning proportionality are not the results of a spurious correlation. I also control for partisanship because it is possible the countries with proportional electoral rules are more prone to left governments, which would create a spurious correlation if it was in fact the partisan identity of the government that impacts corporate governance policy outcomes, as suggested by Roe (2003). To do so, I include a variable for right government, taken from DPI, which is coded 0 for left governments, 1 for centrist governments and 2 for right governments. While this variable has its well known limitations, it is the only data source I am aware of. Its inclusion turns out to be innocuous to the regression estimates of other variables. I control for the log of GDP to guard against the possibility that larger economies have better corporate governance policies, perhaps because of their larger realized or unrealized potential for stock market development, and this could covary with

several of my key independent variables. In models using panel data, I also include a trend term.[21]

4.1.4 Results

Table 1 shows my results for all three models using shareholder voting rights as a dependent variable. Model 1 shows my results using an OLS estimator on panel averages of all of the variables over the observation period. These results suggest mixed support for my hypotheses. The coefficient on *Average District Magnitude* is statistically significant and in the expected, negative direction. As expected, countries with relatively majoritarian electoral institutions have higher levels of corporate governance than country's with relatively proportional electoral systems, even when controlling for legal heritage and the countries history with hyper inflation. Neither of my diffusion variables are statistically significant, and regional diffusion carries the wrong sign. I do find limited support for hypothesis 2a, as *Hyper Inflation* carries a negative coefficient, though it is only significant at the .1 level.

In terms of substantive effects, the impact of hyper inflation is roughly half of the impact of common law. *Average District Magnitude* is smaller still, as a country would have to increase its average district magnitude by 93 - effectively moving from a plurality systems to one of the most proportional systems in the world - in order to effect the same impact as a move from a history of no hyper inflation to a history of hyper inflation.

[21] I found identical results using a trend term or year dummy variables, but the trend term allows for easier interpretation of interactions between my independent variables and time

Table 4.1

Table 4.1: Panel Regression of Shareholder Voting Rights 1993-2002						
Model #	**1**		**2**		**3**	
Estimator	OLS (Panel Averages)		RE		Ordered Probit	
	Coef	**SE**	**Coef**	**SE**	**Coef**	**SE**
Average District Magnitude	-0.008	0.002 ***	-0.008	0.002 ***	-0.010	0.003 ***
Regional Diffusion	-0.137	0.261	-0.655	0.497	-0.122	0.428
Development Diffusion	0.313	0.850	0.176	0.130	0.171	0.547
Hyper Inflation	-0.765	0.412 *	-0.649	0.350 *	-0.967	0.462 **
Year			0.085	0.049 *	0.079	0.053
Common law	1.465	0.392 ***	1.830	0.417 ***	2.426	0.584 ***
Partisanship	-0.122	0.405	0.004	0.048	-0.066	0.121
log GDP	0.258	0.126 **	0.310	0.122 **	0.452	0.152 ***
_cons	-4.214	4.955	-3.960	2.771		
/cut1					10.19	4.3
/cut2					11.67	4.34
/cut3					12.64	4.29
/cut4					14.59	4.59
R-sq/Pseudo R-sq	**0.717**			**0.588**	**0.319**	
N	**23**			226	226	
Country N	**23**			**23**	**23**	

Models 2 and 3 recreate model 1 using panel data. Model 2 uses a linear random effects estimator and model 3 uses a pooled order probit estimator. The results of model 2 and 3 yield remarkably similar results to each other to and to those reported in model 1. *Average District Magnitude* is statistically significant and negative, indicating support for hypothesis 1a. Neither of the diffusion variables are statistically significant. *Hyper Inflation* is again statistically significant and negative, indicating further support for hypothesis 2a. The substantive effects in these models is largely the same as in model 1. *Hyper Inflation* has a larger effect than all but the most dramatic differences in *Average District Magnitude*, but the effect of *Hyper Inflation* is itself much smaller than for *Common Law.*

Robustness Checks

One possible objection to the formulations given above is my operationalization of W_G. The political science literature suggests at least one other possibility. Powell and Whitten (1993) and related literature argue that economic voting is more prevalent in political systems with greater "clarity of responsibility". In order for voters to engage in meaningful economic voting they need to be able to identify who they should blame (or reward) for economic outcomes. In countries with a bicameral legislatures or coalition governments, it becomes difficult for voters to recognize which parties or politicians are responsible for policy outcomes. Powell and Whitten use survey analyses to demonstrate that the relationship between economic outcomes and voting for the incumbent is

weakened in systems low clarity of responsibility. Cheibub (2006) has argued that the plausible deniability accorded to politicians in more opaque systems encourages them to discount the public interest in their policy making. In this view, W_G might be better understood as the propensity of voters to engage in economic voting, rather than its electoral consequences. Because coalition governments are primarily a feature of proportional electoral systems, the coefficient on *Average District Magnitude* may reflect the clarity of responsibility rather than the seat-vote elasticity.

To control for this I rerun models 1-3 with the inclusion of a dichotomous variable coded 1 if there is a bicameral legislature and 0 otherwise, and another coded 1if there is a coalition government and 0 otherwise. Both variables are taken from DPI. The results from these models are noted table 4.2 below. Models 4, 5 and 6 show the results using OLS on panel averages, and on panel data using a random effects linear estimator and a pooled ordered probit estimator, respectively. The results of these models demonstrate that the impact of district magnitude is not sensitive to the inclusion of *bicameral legislature* or *coalition government* controls. The negative and sporadically significant coefficients on *bicameral legislature* and *coalition government* suggest that there may be some credence to the clarity of responsibility arguments even controlling for the seat-vote elasticity.

As a final set of tests I reestimate model 2 and 3 including interactions between my key independent variables and the time trend, allowing me to observe how the explanatory power of my independent variables have changed over the observation period. To be clear, these tests do not bear on any of my hypotheses *per se*. Nonetheless,

Table 4.2

Table 4.2: Panel Regression of Shareholder Voting Rights 1993-2002						
Model #	**4**		**5**		**6**	
Estimator	OLS (Panel Averages)		RE		Ordered Probit	
	Coef	**SE**	**Coef**	**SE**	**Coef**	**SE**
Average District Magnitude	-0.007	0.003 **	-0.010	0.002 ***	-0.015	0.004 ***
Bicameral Legislature	-0.502	0.394	-0.621	0.243 **	-1.546	0.576 ***
Coalition Government	-0.876	0.331 **	0.012	0.116	-0.869	0.391 **
Regional Diffusion	-0.176	0.324	-0.587	0.416	-0.816	0.562
Development Diffusion	0.350	0.578	0.192	0.127	0.300	0.375
Hyper Inflation	-0.848	0.366 **	-0.761	0.284 ***	-1.248	0.493 **
Year			0.079	0.044 *	0.141	0.054 ***
Common law	1.242	0.389 ***	1.665	0.394 ***	3.127	0.714 ***
Partisanship	0.157	0.295	0.001	0.049	0.015	0.105
log GDP	0.303	0.143 **	0.457	0.151 ***	1.033	0.202 ***
_cons	-4.882	4.185	-165.388	88.623 *		
/cut1					306.266	106.18
/cut2					307.481	106.11
/cut3					309.563	105.88
/cut4						
R-sq/Pseudo R-sq	**0.846**		**0.616**		**0.413**	
N	**23**		**223**		**223**	
Country N	**23**		**23**		**23**	

Table 4.3

Table 4.3: Panel Regression of Shareholder Voting Rights 1993-2002				
Model #	**7**		**8**	
Estimator	RE		Ordered Probit	
	Coef	**SE**	**Coef**	**SE**
Average District Magnitude	-0.007	0.002 ***	-0.009	0.003 ***
Average District Magnitude x Year	0.000	0.000	-0.001	0.001
Regional Diffusion	-0.595	0.298 **	-0.039	0.389
Regional Diffusion x Year	-0.035	0.024	-0.034	0.050
Development Diffusion	0.016	0.182	-0.287	0.505
Development Diffusion x Year	0.025	0.052	0.111	0.120
Hyper Inflation	-1.465	0.452 ***	-2.345	0.701 ***
Hyper Inflation x Year	0.218	0.082 ***	0.332	0.144 **
Year	0.078	0.187	-0.244	0.461
Common law	1.845	0.408 ***	2.550	0.558 ***
Partisanship	-0.017	0.028	-0.104	0.124
log GDP	0.326	0.091 ***	0.472	0.159 ***
_cons	-3.897	2.320 *		
/cut1			8.94	4.27
/cut2			10.69	4.31
/cut3			11.72	4.24
/cut4			13.75	4.49
R-sq/Pseudo R-sq	**0.606**		**0.362**	
N	226		226	
Country N	**23**		**23**	

they can help shed some additional light on the processes that are at work. These results are listed in Table 4.3. I find limited evidence that the impact of my explanatory variables other than *Hyper Inflation* varies over the sample period. The insignificant interaction coefficient on A*verage District Magnitude x Year* suggests that this relationship is not significantly different in 2002 as it was in 1993. None of the diffusion variables show any significant interaction over time, indicating that the pressure coming from policy choices overseas has a relatively constant effect (or non-effect, in this case) over the sample period. Including this interaction does have the puzzling effect of generating a negative and statistically significant coefficient on *Regional Diffusion* when using the random effects estimator, possibly suggesting a checkerboard pattern in which countries in the same region specialize in different corporate governance, though the theoretical rationale for such behavior is not obvious, given the lack of a competition for incorporations across countries. Given that this result is not robust to choices of estimators, I do not further speculate to its cause.

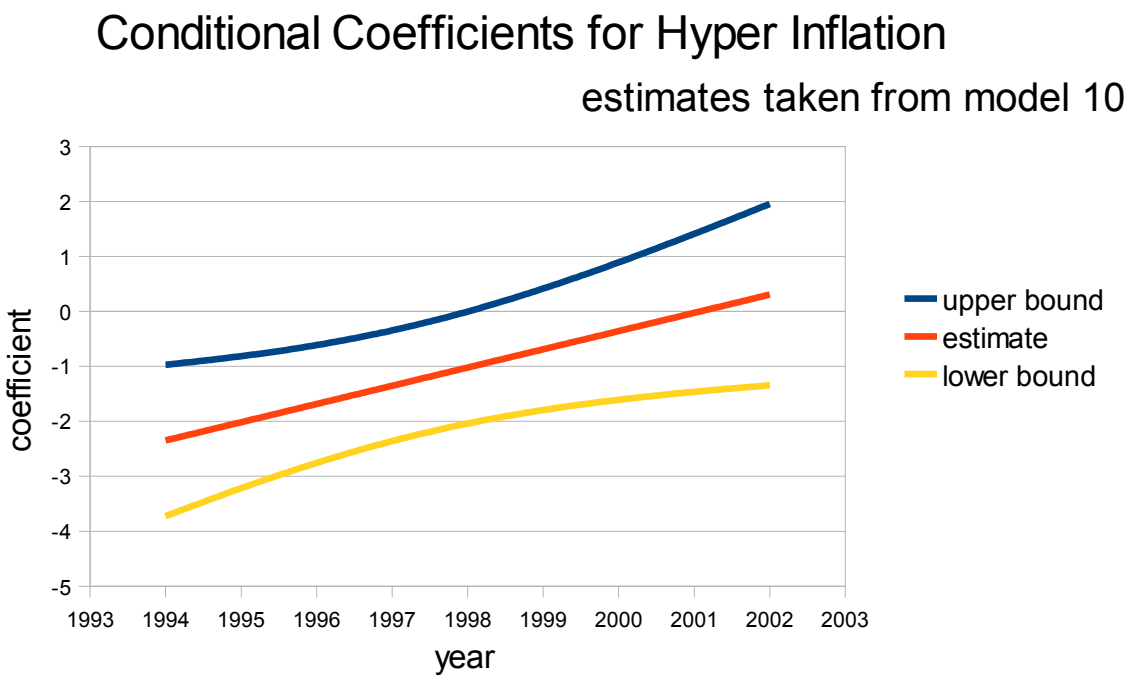
Interestingly, however, the effect of *Hyper Inflation* is found to be significantly attenuated over time, as indicated by the statistically significant and positive coefficient on *Hyper Inflation x Year*. To get a better sense of what this interaction looks like, I computed conditional coefficients for *Hyper Inflation* based on estimates from model 8, which is charted in figure 4.1. Given the stability of the coefficients for *Hyper Inflation* and *Hyper Inflation x Year* across models 7 and 8 the choice of models to base my estimates on is inconsequential. Figure 4.2 shows the conditional coefficient (noted by

the line labeled "estimate") at each year over the sample period. The lines above and below the estimate represent the upper and lower bounds of a 95% confidence interval. When all three lines are on the same side of 0, the estimate is statistically significant at the .05 level. As can be seen, *Hyper Inflation* is statistically significant, and negative, prior to 1997. From 1997 and beyond, the coefficient estimate is statistically insignificant. Given the stability of *Average District Magnitude* and the diffusion variables over times, these results suggest that the increase in corporate governance over the 1990s can be explained by countries that historically lacked pension funds with large financial holdings catching up with countries that historically had pension funds.

There is some anecdotal evidence that this movement is in line with my theoretical expectations. Of those countries which experiences hyper inflation, Mexico underwent significant domestic pension reform over this period and South Korea came under significant pressure from pension funds (and the IMF and World Bank) to increase their corporate governance regimes in the wake of the Asian financial crisis. Both of these countries saw increases in their shareholder voting rights during this period. Other countries that experienced hyperinflation saw increases in institutional investment from foreign pension funds and most (Germany, Italy, Austria and Greece) saw improvements in their shareholder voting rights score, while Turkey, which also saw increases in foreign pension fund investment over this period remained flat. Because of the conceptual shortcomings and ambiguities of *Hyper Inflation* as a proxy for pension fund equity assets, I will resist the temptation to further analyze this finding.

While thought provoking, the above analysis remains substantially limited for

Figure 4.2


Conditional Coefficients for Hyper Inflation
estimates taken from model 10
coefficient
3
2
1
0
-1
-2
-3
-4
-5
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
year
upper bound
estimate
lower bound

reasons noted above. I now turn to my analysis of insider trading laws to correct for some of these shortcomings.

4.2 Insider Trading Laws

Insider trading occurs when an actor with access to non-public information uses that information to trade corporate securities. Non-public information is typically ascertained via a trader's position inside of a firm – as a director, manager or majority shareholder with greater access to firm operations – where they may have special knowledge of unannounced takeover bids, upcoming earnings reports, or any other information that may impact the value of their shares. There are several reasons, both substantive and methodological, why insider trading makes a useful policy domain for my purposes.

First, insider trading highlights the distributional conflict at the heart of the political competition over investor protection. By definition, not every trader has equal access to non-public information; only certain actors enjoy a unique advantage. When insider trading is banned, information traders – traders who invest in knowledge of publicly available information – can profit from the informational advantage gleaned from their research. When insider trading is allowed, however, insiders will routinely beat information traders in the market, thereby undermining those traders' material incentives to participate in securities trading (Goshen and Parchomovsky, 2001, summarized in Beny 2005, 2007). In so doing, unchecked insider trading depresses the value of shares held by shareholders that are not privy to insider information, regardless of whether they

are engaged in active trading.

The distributional consequences of insider trading are not confined to information traders and other minority shareholders. Bushman, Piotroski and Smith (2005) demonstrate that analyst following – a proxy for the degree of investor interest in a firm – increases after the enforcement of an insider trading ban, particularly in emerging markets. Similarly, Bris (2005), Bhattarchaya and Douak (2000) and Beny (2005, 2007) all find that insider trading laws increase stock market liquidity. By reducing the expected returns for outside holders of securities and thereby lowering the demand for corporate securities by outside investors, allowing unfettered insider trading increases firms' cost of capital (ex. Beny 2005; Bhattarchaya and Douak 2002). This has welfare implications for entrepreneurs in countries without an effective ban on insider trading who are less able to raise new funds on capital markets, the public who has an implicit interest in a healthy capital market and its ability to finance the "real" economy, and politicians whose reelection prospects are tied to the health of the real and financial economy.

A second reason to study insider trading laws is that these laws have become an increasingly common feature of national – and in the case of the EU, transnational – regulatory landscapes. The first recognizable insider trading law was enacted as part of the Securities and Exchange Act of 1934 in the U.S, which banned a variety of profit making trades by corporate insiders, the precise definition of which has changed over time through case law.[22] Other countries were initially slow to adopt insider trading

[22] Corporate insiders are defined as management and shareholders holding a 10% stake or higher in a company. In the time since the adoption of the Securities and Exchange Act, SEC rulings and judicial decisions have widened the definition of corporate insider to cover a considerably larger category of transactions. Virtually all trades knowingly made on the basis material non-public information, regardless of the traders connection to the firm or the channels through which that information was gleaned are now considered insider trading. More specifically, The SECs 1961 decision *In re Cady,*

prohibitions. The United States remained the only country with a law in place until 1967, when Canada banned insider trading, followed closely by France in 1968. By 1980, nearly fifty years after the Securities and Exchange Act, only nine other countries had adopted a comparable law.[23] By 1999, however, that number had exploded to eighty-seven, including almost every country with a stock market. Enforcement rates have seen similar growth, but on a smaller scale. The United States first enforced its insider trading law in 1951. The next country to enforce an insider trading law was France in 1975. Twelve countries had enforced insider trading laws by 1990 and thirty eight countries had prosecuted at least one insider trading case by 1999.

A third reason to explore the diffusion of insider trading laws is that, unlike dependent variables used in previous studies of investor protection, the relatively recent spread of insider trading prohibitions allows me to observe the exact political and economic conditions under which these laws were first adopted and enforced. Focusing on insider trading laws thus gives me considerably more insight into the political-economic determinants of investor protection than regressions using shareholder voting rights. With the exception of the United States, whose 1934 insider trading law predates

Roberts & Co, which was upheld in federal circuit court in *SEC v. Texas Gulf Sulphur Co* (1966), widened the the definition of corporate insider to include tipping. Tipping, made famous recently by the Martha Stewart prosecution, occurs when material non-public information is transferred from a corporate insider to an outsider and is then used as the basis for securities trades by the outsider. The resulting precedent extended insider trading to include trades made by anyone knowingly trading on material non-public information ("tipees") and the originators of said information ("tippers"). The breadth of trades considered insider trades was narrowed somewhat in Chiarella v. United States, 445 U.S. 222 (1980) on the grounds that insider trading is only fraudulent is there as in expectation that the trader has a fiduciary duty to the firm's stock holders. This ruling prompted the SEC to issue rule 14e-3, the misappropriation rule, which makes it illegal for anyone to trade on insider information if they know that the information is not-public. Similarly, in Dirks V. SEC, 463 U. S. 646 (1983), Justice Powell established "constructed insiders", explicitly expanding the definition of insiders to include securities lawyers, analysts and other that might, in their normal business activities come to posses inside information.

[23] These countries were: Brazil, Canada, France, Malaysia, Mexico, Nigeria, Singapore, South Korea and Sweden.

my sample, I am able to build a dataset that observes the transition from allowing insider trading to a ban on insider trading for every country with a stock market and every instance of a move from having an unenforced insider trading laws to an enforced one.

Fourth, unlike corporate governance rules, insider trading prohibitions have the same meaning in countries dominated by closely held firms and countries dominated by diffusely owned firms. It is entirely possible that the results concerning shareholder voting rights are being driven by a scenario in which countries with diffusely held firms developed corporate governance rules that solve the agency problems inherent in that setting, while countries with closely held firms developed a set of corporate governance rules that reflect the agency problems inherent in that setting. It is perhaps no surprise that the countries with the most diffusely held firms – the United States and the United Kingdom - also have the corporate governance schemes that are most useful to the oversight of these sorts of firms. Insider trading rules pose no such problems.

For my analysis I use two dependent variables, one that notes the year of insider trading law adoption and one that notes the initial enforcement. Both measures are dichotomously coded such that "1" denotes either the adoption or enforcement of a law and "0" denotes that such an event has not yet taken place. These data were taken from Bhattacharya and Daouk (2002).

4.2.1 Sample

To test the validity of my hypotheses in the context of insider trading laws I construct a country-year dataset for the years 1951 to 1999 for the 84 democracies with functioning

stock markets, though missing data on the independent variable reduces my sample to 55 countries. My data is disaggregated ("grouped") by the country-year.[24] I limit myself to democracies because electoral proportionality has little meaning in a non-democratic state. Unlike with shareholder voting rights, this dataset is not limited to OECD countries, and there is a meaningful amount of variation in the "democraticness" of non-OECD countries. I define democracy very leniently, allowing any country with a polity score over 0 (polity scores range from -10 to 10) into my sample. In practice, my measure of electoral law proportionality is coded as missing for virtually all country-years below this threshold.[25] My sample is limited to the years 1951-1999 because data on the dependent variables are only available through 1999 and data on some of my independent variables begin in 1950, which, because of lagged variables, effectively begins my sample in 1951. Not every country is represented in every year because 1) democracy scores fluctuate over time; and 2) not every country has an operating stock exchange for the entire period.

4.2.2 Method

Given the nature of my data and hypotheses, the appropriate estimation technique is event history analysis using a single failure-event per cross-section data structure. I report results using the semi-parametric Cox proportional hazards estimator (using the Efron

[24] Organizing the data by country-year is not the only way of organizing the data. I could also consider each spell of democratic government as its own cross section. In this way, Pakistan, for example, would enter the regression analysis separately 4 times, once for every time its polity score crossed zero during the sample. Reorganizing the data in this way does not alter my findings.

[25] Using higher thresholds does not change my core results.

method of dealing with ties[26]) and a fully parametric event history model using a log-normal distribution, which I found to be the best fit to the data by inspecting the baseline hazard and comparing Akaike Information Criterion across alternative specifications.[27] The advantages and disadvantages posed by the Cox estimator are well known in the political science (see Box-Steffensmeier and Jones 1997, Box-Steffensmeier and Zorn 2002, Box-Steffensmeier and Jones 2004). Chief among the advantages are its flexibility with respect to the underlying duration dependence, with the trade off being that that these models can be inefficient in the face of multiple "ties" - instances of multiple units exiting the sample simultaneously - which is a recurrent feature of my data. A further complication posed by the use of a Cox model is the proportional hazards assumption. As noted by several authors, violations of this assumption can lead to biased results (Box Steffensmeier, Reiter and Zorn 2003). Diagnostic tests examining the scaled Schoenfeld residuals fail to reject the null hypothesis that the proportionality assumption is satisfied. The fully parametric alternative makes stronger assumptions about duration dependence, but is more efficient in the face of frequent ties and, in its log-normal specification, does not carry a proportionality assumption.

The directionality of Cox model coefficients are identical to OLS coefficients: positive coefficients suggest that an increase in a variable increases the probability of failure (in the case, failure means the adoption or initial enforcement of insider trading laws), negative coefficients indicate the opposite. The coefficients of log-normal models are reported in accelerated failure time format. In accelerated failure time a negative

[26] My results are robust to estimations using either the Efron or Breslow method

[27] Unreported robustness checks using binary time series cross-sectional methods, reveal effectively the same results.

coefficient indicates that increases in this variable accelerates failure time (i.e. shortens the time to failure), while a positive coefficient indicates that increases in the variable decelerates failure time (i.e. lengthens the time to failure). In terms of directionality, this is opposite of how coefficients from proportional hazards models (or OLS regressions) are interpreted.

A requirement of event history models is the specification of an underlying time counter. For my models of insider trading law enforcement this is straightforward: the counter starts in the year of insider trading law adoption. Starting at the date of adoption also has the advantage of ensuring that my findings in my enforcement models capture an entirely different set of data than my adoption model. Because one sample begins at the moment the other ends, there can be no overlap. The coding is less clear for my models of insider trading law adoption. While many countries began stock exchange operations during the 19th and 20th century, other countries had active stock markets for centuries before they adopted an insider trading law. Substantively, it is not clear whether the existence of a pre-modern stock market should matter for my analyses. My solution is to begin the counter at the start of the post-war era or in the first year of stock market operations if trading began more recently than 1946.

4.2.3 Independent Variables

I operationalize proportionality differently than in my tests using shareholder voting rights. Whereas my concern in the former tests was using a measure that was not coded for the years 2001 and 2002, my sample in these tests does not extend beyond 2000. It

does, however, extend back to 1951, 24 years before the DPI coding begins. To accommodate this I use a using a measure of median district magnitude taken from Golder (2005). I subtract 1 from *Median District Magnitude*[28] (making the minimum observed value equal to 0, rather than 1) to make the coefficients reported in the regression tables more meaningful in light of my more frequent use of interaction terms in these tests.[29]

I construct my diffusion variables in a similar fashion as before, with the only differences being necessitated by the fact that variable is dichotomous rather than ordinal. I measure *Regional Diffusion* by calculating the percentage of countries in the same region that have banned insider trading, using the same regional definitions as with shareholder voting rights. As before, I construct a variable called *Development Level Diffusion* by calculate the absolute value of the difference in the log of GDP per capita for every dyad of countries that operate stock exchanges (not just those included in my sample). For each country-year, I then calculate the percentage of countries that have banned insider trading among those whose GDP per capita is similar enough that the absolute value of the difference of logged GDPs per capita is less than .3. For the most part, this produces intuitive pairings. Calculating Poland's value in 1999 uses information from 21 countries, including Brazil, South Africa, Slovakia, Russia, Lebanon, Mexico and Thailand. Computing a score for the United States in 1999 includes data from Australia, Austria, Canada, Denmark, Iceland, Kuwait, Luxembourg,

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[28] While median district magnitude is a better conceptual fit to my research question, the Golder dataset al.so computes a measure of average district magnitude, which produces almost identical results.

[29] This transformation is made solely to make the regression tables slightly more meaningful and makes no change to my findings, which, in any event, are better established by graphs of conditional coefficients.

Netherlands, Norway, Singapore and Switzerland. This variable also reflects development over time. Computing a value for Ireland in 1979 uses information from Portugal, Venezuela, Argentina, Spain, Singapore and Greece. Ireland's 1999 score uses information from 28 countries including Austria, Canada, France and the Netherlands. Some less meaningful pairings do arise. Kuwait, for example, does not have a stock market that is similar to the American stock market it any meaningful sense, despite the similarities in GDP per capita. Despite the occasionally odd pairing, I believe this technique has produced valid measures of the extent to which a country faces competitive pressures from policies in its development level cohort.

My proxy for pension funds holdings poses problems in this larger dataset as *Hyper Inflation* requires data on historical inflation rates, which are unavailable for many non-OECD countries. However, while financial markets were well developed in many OECD countries even during the economic dislocation of the early 20th century, this was not the case outside of the OECD, and there was no serious alternative to a pay-go system, particularly given the heavy capital controls in place when these countries began pension systems in the 1950s and 1960s. As such, I limit my coding of *Hyper Inflation* to only be coded 1 for OECD countries that experienced hyper inflation prior to their pension system's creation.

Control Variables

As with shareholder voting rights, I control for *Common Law* using a dummy variable

indicating British legal heritage and the log of GDP. I don't control for government partisanship because the DPI measure used in my shareholder voting rights models is only coded for years from 1975 onward, considerably after my sample begins. Including this variable requires me to eliminate several early law adoptions and enforcements and this non-random elimination of observations introduces bias that is not justified, particularly given the explanatory limitations of the variable itself.[30] Given the focus on a specific policy change, rather than a level of policy, it is possible that countries with more veto players, which correlates strongly with proportional electoral laws, would be less likely to adopt or enforce insider trading laws, creating potentially spurious results. I control for the number of *Veto Players* using Polcon_iii from Henisz's Database of Political Constraints.[31]

European countries demand special attention in the analysis. The European Community Insider Trading Directive (ECITD) of 1989 prohibits insider trading in all E.U. member states. Under ECITD, national lawmakers in the E.U. were expected to adopt insider trading prohibitions by 1992, though in practice several of these countries already had laws in place and others did not adopt insider trading laws until several years later. Enforcements are unaffected by the ECITD. To accommodate this, I include a Europe dummy variable to allow for a separate European intercept.[32] I also include a

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[30] In unreported robustness checks I find similar, though not identical, results from models using the variable.

[31] I use *Polcon_iii* instead of *Polcon_iv* because the latter has a significant amount of missing data and includes measures of sub-national units of government and judicial independence, neither of which reflect my theoretical reasons for including veto players in my analysis. I prefer the polcon variable to the checks variable taken from Keefer et al. (2000) because the latter only extends back to 1975, well after countries began adopting and enforcing insider trading laws.

[32] The separate Europe intercept turns out to be inconsequential to my estimates. In unreported robustness checks I found very similar results using a Europe-only sample as well as a non-European sample. These regressions are available from the author on request.

dichotomous indicator for Israel. Israel's large district magnitude and early adoption and enforcement of insider trading (12th earliest adopter and 7th earliest enforcer in my sample) make it a significant outlier. The impact of Israel on the results is substantial, and all of my results rely on the inclusion of an Israel dummy or excluding the case, which yields similar results. Therefore, I include the Israel dummy variable in all models. Finally, I include a trend term capturing the year.[33] It is certainly possible that that there are a host of trends correlated with the year, rather than the underlying time–counter, that is not captured in my diffusion variables. I include a trend term marking the year to avoid this form of spurious correlation.

4.2.4 Insider Trading Law Adoption Results

My first analysis examines the adoption of insider trading laws. Table 4.4 shows my results, with model 1 reporting the results from a Cox Proportional Hazards Model and model 2 reporting results from a Log-Normal model. To reiterate, my expectation is that the likelihood of adopting insider trading laws decreases in median district magnitude, increases in my diffusion variables and that that the impact of each is conditional on the other. Electoral law's impact on insider trading rules should be most evident in country-years that face relatively little competitive pressures and competitive pressure's impact should be greatest in country-years using proportional electoral rules. As such I expect to find a conditionally negative (positive in the log-normal model) coefficient on M*edian District Magnitude,* a conditionally positive (negative in the log-normal model)

[33] As before, there is no difference between the inclusion of a trend term of year dummy variables.

coefficient on my diffusion variables and a positively (negatively in the log-normal model) signed interaction term. I also expect to find a negative (positive in the log normal model) coefficient on *Hyper Inflation,* which would indicate that the likelihood that a country adopts an insider trading law is lower in countries that have historically lacked pension funds with large financial holdings.

The results of models 1 and 2 show considerably more support for my hypotheses than in models using shareholder voting rights. Beginning with model 1, I find that *Median District Magnitude* is statistically significant and negative, indicating that when both of the diffusion variables are set to 0, countries with more proportional electoral rules are slower to adopt a ban on insider trading than countries with relatively majoritarian electoral laws. Neither of the diffusion variables are statistically significant, indicating that when *Median District Magnitude* is equal to zero, as it is in plurality systems, competitive diffusion has no discernible impact on the likelihood of adopting an insider trading law. This is not inconsistent with my hypotheses, given that the diffusion variables are predicted to have more explanatory power when electoral laws are more proportional. Of the interaction terms, only *Regional Diffusion x Median District Magnitude* is statistically significant, and it bears the correct sign. As expected, *Hyper Inflation* is negatively signed and statistically significant.

Model 2 re-estimates model 1 using a log-normal estimator. As noted above, the accelerated failure time format of the coefficients mean that the predicted directionality is the opposite of what it was using the Cox model. The results reported in model 2 are similar, if a bit stronger, than those reported in model 1, which is not surprising given the

Table 4.4: Regression Estimates for Insider Trading Law Adoption				
Model #	1		2	
Estimator	Cox		Log Normal	
	Coef	SE	Coef	SE
proportionality	-0.038	0.018**	0.065	0.028**
regional diffusion	0.161	0.968	-0.741	1.066
regional diffusion x proportionality	0.075	0.036**	-0.151	0.073**
development level diffusion	0.762	0.818	-1.342	0.788*
development level diffusion x proportionality	-0.014	0.031	0.070	0.073
Hyper Inflation	-1.024	0.521**	1.180	0.422***
Israel	4.998	1.503***	-4.508	2.527*
Europe	1.309	0.452***	-0.634	0.358*
Veto Players	0.382	0.396	-0.063	0.358
Common Law	-3.199	1.636*	2.147	0.831***
log GDP	0.157	0.138	-0.141	0.085*
year	0.131	0.046***	-0.055	0.029*
cons			115.039	56.573**
log psuedolikelihood	-79.84		-8.15	
N	824		824	
Country N	50		50	

increased efficiency of the fully parametric estimator. *Median District Magnitude* is statistically significant and positive, indicating once again that countries with more proportional electoral laws are slower to adopt a ban on insider trading when the diffusion variables are set to 0. *Regional Diffusion* is once again statistically insignificant, but the statistically significant and negative coefficient on *Region Diffusion x Median District Magnitude* suggests support for my hypotheses. *Development Level Diffusion* is statistically significant and negative, again indicating support for my hypotheses, but the insignificant coefficient on *Development Level Diffusion x Median District Magnitude* suggests that this effect is unconditional. As before *Hyper Inflation* is statistically significant and negative, indicating that countries that have historically lacked pension funds are slower to adopt bans on insider trading.

To get a better sense of these results, I turn now to charts of the conditional coefficients, which I calculated from estimates in model 2. Figure 4.3 shows the conditional coefficients for *Median District Magnitude* at a range of each of the diffusion variables that corresponds to the 10^{th} through the 90^{th} percentile range of that variable in the sample. As before, I graph three lines in each figure: a point estimate and the upper and lower bounds of a 95% confidence interval. When all three lines are on the same side of zero, the point estimate is statistically significant at the .05 level. For each set of conditional coefficients I held the other diffusion variable at its sample mean.

The panel on the left hand side of figure 4.3 notes the conditional coefficients for *Median District Magnitude* at a range of values for *Regional Diffusion*. In line with the incorrectly signed, and statistically insignificant interaction term noted in Table 4.2, this

Figure 4.3

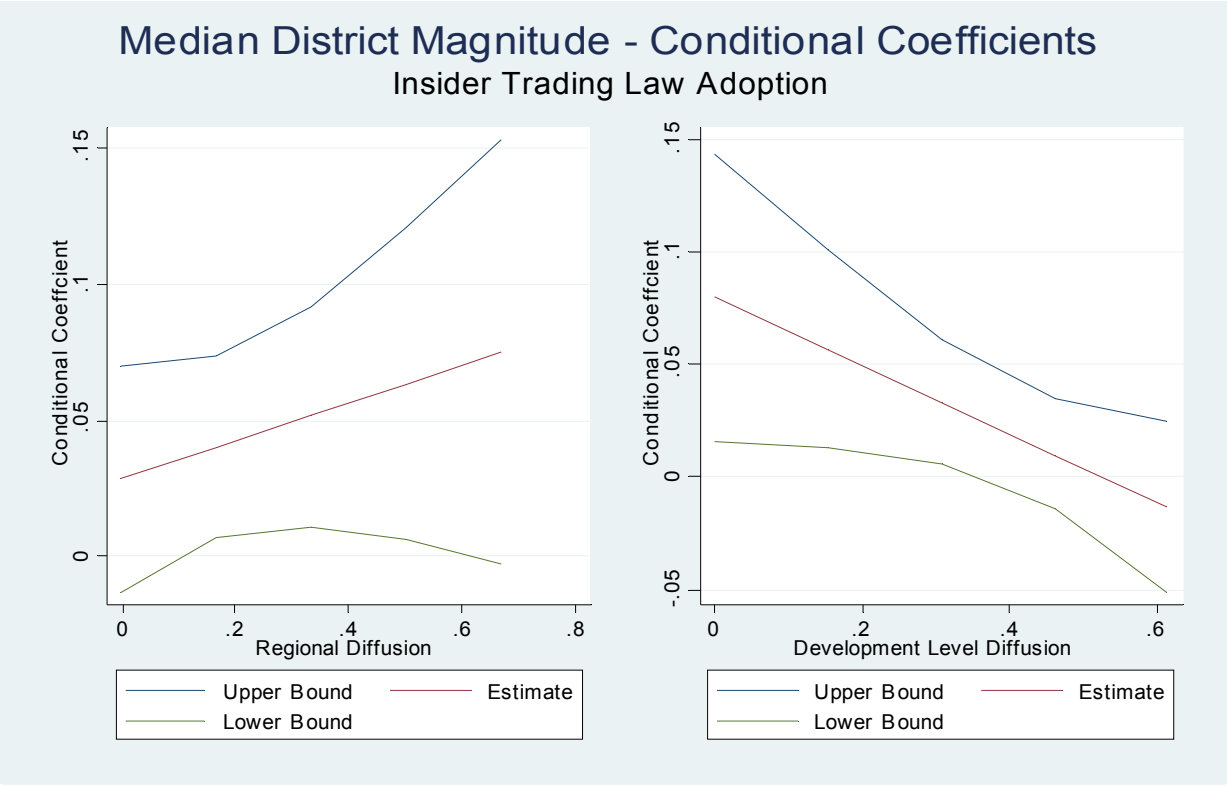
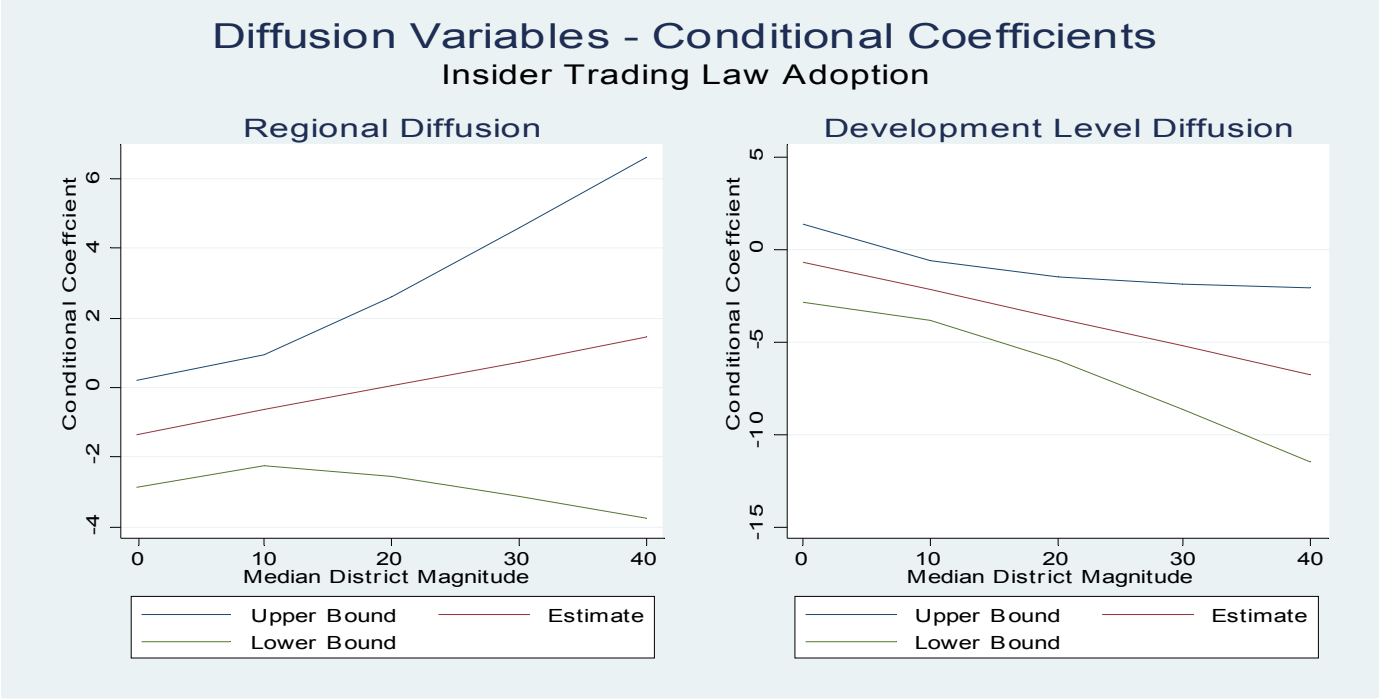

Median District Magnitude - Conditional Coefficients
Insider Trading Law Adoption
Conditional Coeffcient
0
.05
.1
.15
0
.2
.4
.6
.8
Regional Diffusion
Upper Bound
Estimate
Lower Bound
Conditional Coeffcient
-.05
0
.05
.1
.15
0
.2
.4
.6
Development Level Diffusion
Upper Bound
Estimate
Lower Bound

Figure 4.4


Diffusion Variables - Conditional Coefficients
Insider Trading Law Adoption
Regional Diffusion
Conditional Coeffcient
-4
-2
0
2
4
6
0
10
20
30
40
Median District Magnitude
Upper Bound
Estimate
Lower Bound
Development Level Diffusion
Conditional Coeffcient
-15
-10
-5
0
5
0
10
20
30
40
Median District Magnitude
Upper Bound
Estimate
Lower Bound

graph does not conform with expectations. *Median District Magnitude* is statistically insignificant at the upper and lower reaches of *Regional Diffusion,* and statistically significant and positive in between. Note that the width of the 95% confidence suggests that the upwards slope of the line is itself insignificant, as one could manually "tilt" the point estimate downwards to support a negative slope without moving outside of the confidence interval.

The panel of the right hand side notes the conditional coefficients for *Median District Magnitude* at a range of values for *Development Level Diffusion.* This chart is in line with expectations. *Median District Magnitude* is statistically significant at low levels of *Development Diffusion* and converges towards zero as *Development Level Diffusion* rises, becoming statistically insignificant when *Development Level Diffusion* reaches .37, indicating that 37% of countries that are in a similar development level have adopted an insider trading law.

Figure 4.4 notes the conditional coefficients for both diffusion variables evaluated at different values of *Median District Magnitude.* The panel on the left shows the conditional coefficients for *Regional Diffusion.* As before, these results do not conform to my expectations. *Regional Diffusion* is statistically insignificant at all levels of *Median District Magnitude,* and the wide confidence interval around the point estimates reinforces that statistical insignificance of the interaction effect. The panel on the right shows the conditional coefficients for *Development Level Diffusion.* These coefficients do conform to expectations. The coefficients are insignificant at very low levels of *Median District Magnitude*, but become statistically significant and negative at high

levels, indicating that countries whose development level peers have adopted insider trading laws are quicker to adopt such laws themselves when those countries use proportional electoral laws. The threshold of statistical significance is a median district magnitude of 7, which constitutes over 45% observations in the data and encompasses 20 countries.

4.2.5 Insider Trading Law Enforcement Results

I now turn to my analysis of insider trading law enforcement. Models 3 and 4 replicate models 1 and 2 using the initial enforcement of an insider trading law as the failure event. Model 3 shows the results using the Cox estimator. The negative coefficient on *Median District Magnitude* suggests that countries with more proportional electoral laws are slower to enforce their bans on insider trading laws when both diffusion variables are held to 0. *Regional Diffusion* is insignificant, while *Development Level Diffusion* is marginally significant, but bears the incorrect sign. However, the interaction terms between *Median District Magnitude* and the diffusion variables are both positive, as expected, and statistically significant, though *Development Level Diffusion x Median District Magnitude* is only significant at the .1 level. *Hyper Inflation* is insignificant, indicating no connection between the presence of financially invested pension funds and the speed with which countries enforce their insider trading laws once they have been enacted.

Model 4 replicates model 3, except that it is estimated using a log-normal

Table 4.5: Regression Estimates for Insider Trading Law Enforcement						
Model #	**3**			**4**		
Estimator	**Cox**			**Log Normal**		
	Coef	**SE**		**Coef**	**SE**	
Median District Magnitude	-0.387	0.140	***	0.198	0.056	***
Regional diffusion	1.142	1.289		-0.370	0.693	
Regional diffusion x proportionality	0.131	0.061	**	-0.073	0.035	***
development level diffusion	-2.873	1.543	*	1.181	0.659	*
development level diffusion x proportionality	0.294	0.155	*	-0.146	0.065	**
Hyper Inflation	-0.388	0.633		0.453	0.336	
Israel	34.767	13.54	***	-18.253	5.397	***
Europe	0.960	0.538	*	-0.797	0.255	***
Veto Players	0.064	0.529		-0.164	0.277	
Common Law	3.118	2.264		-0.220	0.870	
log GDP	0.753	0.170	***	-0.392	0.085	***
year	0.096	0.054	*	-0.055	0.026	**
cons				121.903	52.472	**
log psuedolikelihood	**-64.3**			**-20.17**		
N	**362**			**362**		
Country N	**57**			**57**		

estimator. The results are similar to model 3. *Median District Magnitude* is again statistically significant and bears the correct sign. *Regional Diffusion* is again insignificant, and *Development Level Diffusion* is again marginally significant, but in the wrong direction. The interaction terms are, again, both in the anticipated direction and in this model both coefficients are statistically significant at the .05 level. *Hyper Inflation* is once again statistically insignificant.

As before, a better sense of the results can be gleaned from examinations of the conditional coefficients, which I take from the estimates generated in model 4 and plot in Figure 4.5. The left hand panel shows the conditional coefficients for *Median District Magnitude* evaluated at a range of values for *Regional Diffusion*. My hypotheses suggest that the coefficient on *Median District Magnitude* should be significant and positive at low values of *Regional Diffusion* and converge to 0 as *Regional Diffusion* takes on higher values. That is indeed what I find, with the coefficient becoming statistically insignificant when 88% of a countries regional peers have adopted a ban on insider trading. The right hand panel shows the conditional coefficients for *Median District Magnitude* at a range of values for *Development Level Diffusion.* Here too, the coefficient on *Median District Magnitude* is positive and declining in *Development Level Diffusion*, becoming statistically insignificant when 93% of a country's regional peers have baned insider trading.

Figure 4.6 shows the conditional coefficients for both diffusion variables, evaluated at a range of values of *Median District Magnitude.* Both diffusion variables are statistically insignificant at low levels of median district magnitude but become

Figure 4.5

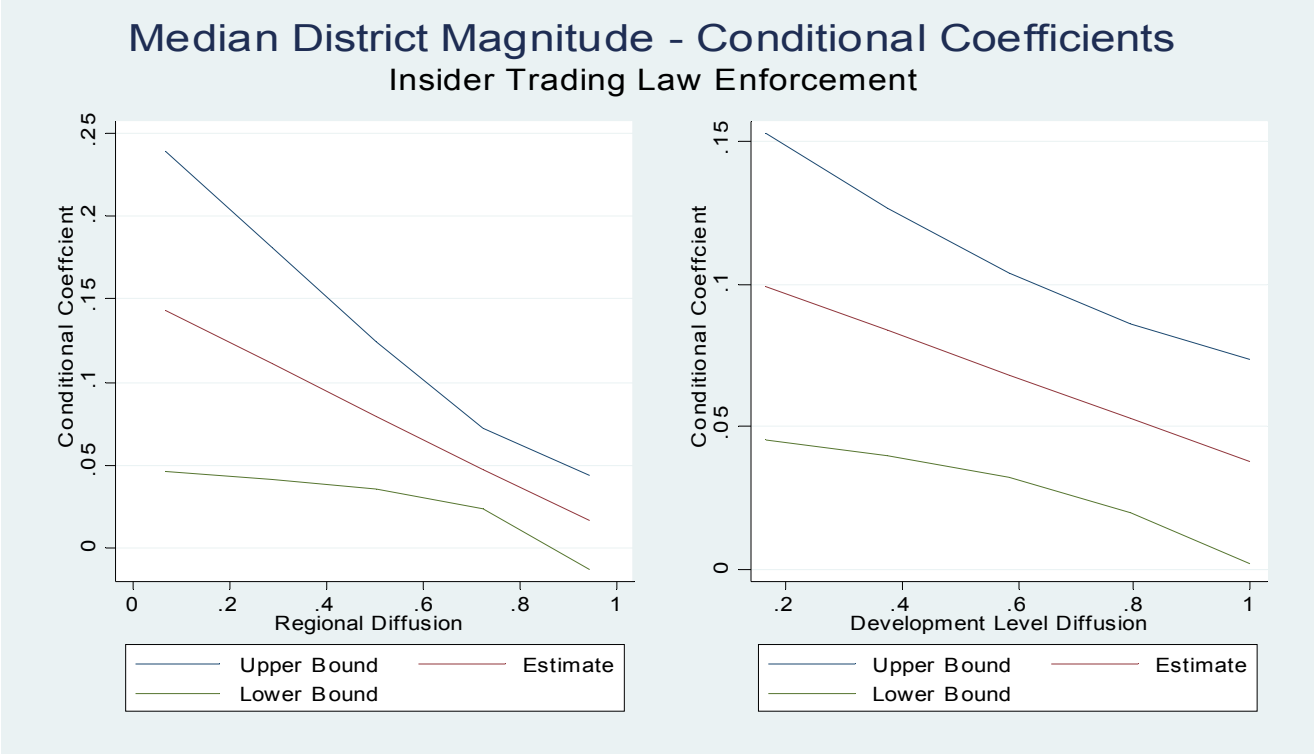
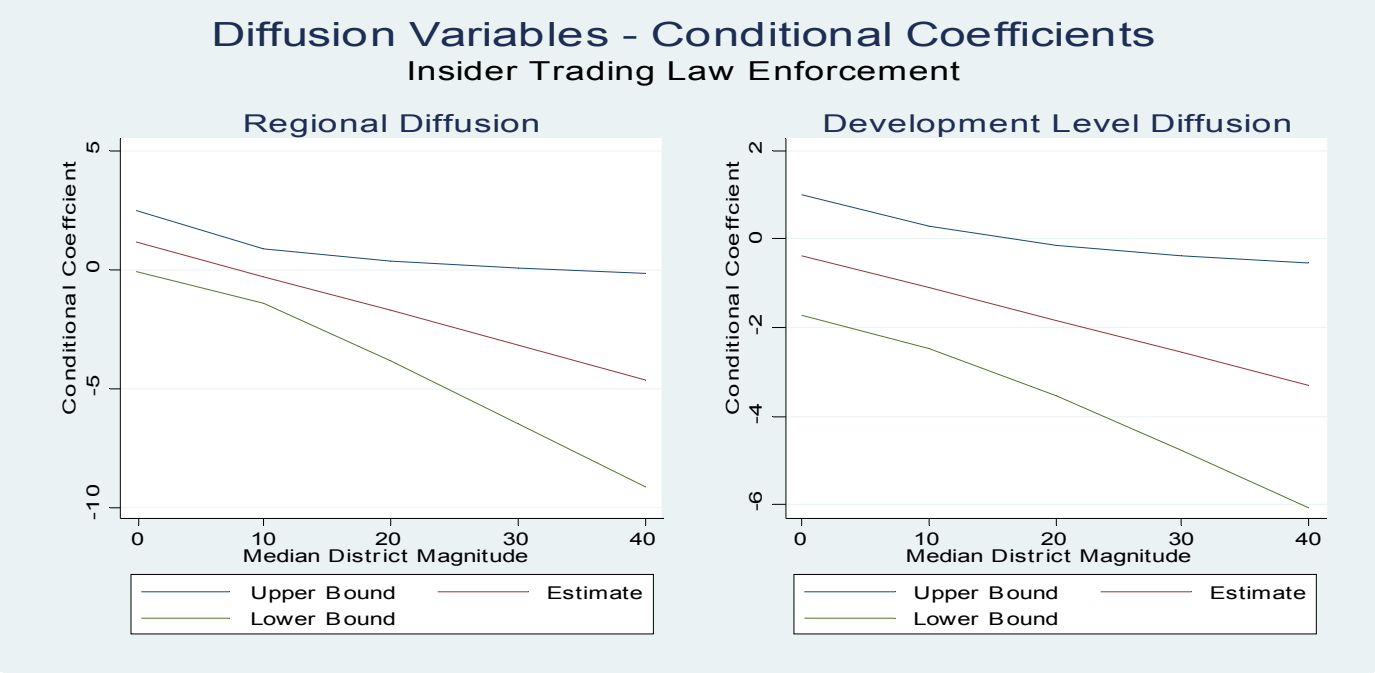

Median District Magnitude - Conditional Coefficients
Insider Trading Law Enforcement
Conditional Coeffcient
0
.05
.1
.15
.2
.25
0
.2
.4
.6
.8
1
Regional Diffusion
Upper Bound
Estimate
Lower Bound
Conditional Coeffcient
0
.05
.1
.15
.2
.4
.6
.8
1
Development Level Diffusion
Upper Bound
Estimate
Lower Bound

Figure 4.6


Diffusion Variables - Conditional Coefficients
Insider Trading Law Enforcement
Regional Diffusion
Conditional Coeffcient
5
0
-5
-10
0
10
20
30
40
Median District Magnitude
Upper Bound
Estimate
Lower Bound
Development Level Diffusion
Conditional Coeffcient
2
0
-2
-4
-6
0
10
20
30
40
Median District Magnitude
Upper Bound
Estimate
Lower Bound

significant and negative as *Median District Magnitude* takes on higher values. In this case, *Regional Diffusion* diffusion becomes statistically significant in countries with median district magnitudes at or above 32, while *Development Level Diffusion* is statistically significant for country-years with median district magnitudes at or above 16. As before, these conditional coefficients support my hypotheses concerning the interaction of electoral laws and international competition.

4.3 Summary

The primary purpose of the foregoing tests were to determine the validity of my hypotheses that 1) countries with more majoritarian electoral rules will have more protections for minority shareholders, 2) countries that face more competitive pressures will have more protections for minority shareholders, and 3) that the impact of these factors will be conditional on one another in the context of insider trading laws. I found overwhelming evidence that countries with more proportional electoral rules have fewer protections for minority shareholders than countries with majoritarian electoral rules. I found no evidence of a competitive diffusion process in my analysis of shareholder voting rights, but did find such evidence in my analysis of insider trading laws. Furthermore, as expected, I found considerable evidence that the impacts of competitive diffusion and electoral laws in the adoption and enforcement of insider trading rules are conditional on one another in the fashion predicted by my hypotheses.

I also found that countries that had experienced hyper inflation prior to establishing their national pension systems had lower levels of shareholder voting rights

and were slower to adopt insider trading laws. To the extent that previous episodes of hyper inflation is a valid proxy for the presence of pension funds that are willing to engage in corporate governance policy making, this suggests some support for hypothesis 2a as well. However, the validity of this proxy is limited, at best. I more fully evaluate the impact of pension funds in the corporate governance policy making process in Section II.

Section II A Closer Look at Pension Funds

> *"The largest institutional investors, the group that includes the largest collection of investment capital in the world, are the pension funds. One of the most important elements to understanding the current state of corporate governance, as well as its future direction and potential, is an understanding of this group"*
>
> *- Robert Monks and Nell Minow, Watching the Watchers: Corporate Governance for the 21st Century.*

Berle and Means (1932), analyzing the prospects for corporate governance in the American corporation, famously characterized the shortcomings of a firm owned by a large set of small shareholders. In the Berle-Means corporation, individual investors are simply too dispersed with too small of an ownership stake to overcome barriers to collective action and meaningfully participate in corporate governance matters. Without a way to overcome barriers to collective action, owners will not be able to properly monitor management, who will often operate the firm in order to maximize their own utility, rather than to maximize profits. As noted in the introduction, this can lead to asset stripping, empire building, or simply lackadaisical management, the so called "quiet life" (Bertrand and Mullainathan 2003). While not discussed by Berle and Means, the same is true in the policy arena, but more so. With precious few exceptions, individual shareholders are not able to coalesce into a meaningful lobby group. They are too diffuse, and their individual financial interests are too small. Institutional investment offers a remedy to both of these corporate governance dilemmas.

In the non-Berle-Means corporation, the key agency problem is between minority shareholders and majority shareholders. In this situation, barriers to collective action

among minority shareholders within the firm are less meaningful. Even a perfectly organized block of minority shareholders would still be unable to prevent majority shareholders, in whom lies effective control of the firm, from appointing directors that are beholden to their interests and not the firm's. Institutional investment offers possible solutions here as well. Institutional investors have the clout, even in a closely held corporation, to demand concessions such as designated board seats and, moreover, have the ability to simply sell large amounts of shares issued by firms with unchecked agency problems, depressing share value in the process. As in the previous scenario, only institutional investors can hope to effectively lobby for a legal environment that reins in the potential excesses of majority shareholders.

However, not all institutional investors play this role in corporate governance matters. The role that institutional investors play in the corporate governance of firms they own is often contextually specific to the country they operate in. In Germany and Japan, for example, banks have historically held a large amount of corporate equity and have played an active role in the corporate governance regimes of those countries. In the United States, by contrast, a variety of regulatory measures, such as those on interstate banking and Glass-Steagall, have historically prevented American banks from playing a significant role in corporate governance at the firm level or the policy level (as was their purpose).

Other factors also mediate the impact of institutional investors. Life insurance companies, for example, command enormous pools of financial assets, but the predictable nature of their liabilities often leads them to invest disproportionately in fixed income

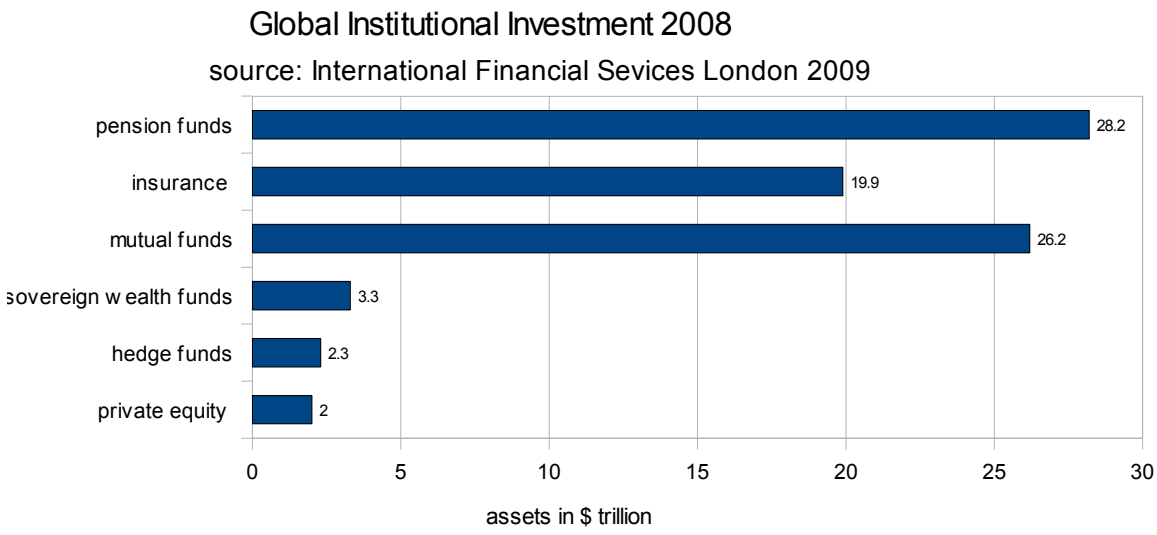
assets rather than stocks.[34] In the United States, insurance companies' ability to hold shares was historically limited by statute as well (Roe 1993). Even when insurance companies do take out equity stakes, their willingness to get involved in corporate governance is often mitigated by the lucrative side business they perform for their corporate clients. Mutual funds and other financial companies typically face similar disincentives as insurance companies to get involved in corporate governance issues, though some exceptions, notably Vanguard Funds, do exist. Very recently, hedge funds have become active within the firms they invest in, but this has not yet spilled over into policy activism (Partnoy and Thomas 2007).

The remaining class of institutional investor is the pension funds, the largest single source of institutional investment in the world and the only one with a significant track record of corporate governance activism. The assets under management of pension funds – including publicly and privately administered funds – are massive. As Figure II.1 shows, in 2008 the globally aggregated assets of pension funds stood at $28.2 trillion. Total holdings by pension funds worldwide were equal to almost half of world GDP in 2008, and more than twice the 2008 US GDP (IMF 2009). These funds are enormous individually, as well as in the aggregate. Figure II.2 shows the size, in 2008, of the worlds largest individual pension funds. Given the often onerous restrictions on communication between proxy voters and other free riding problems, the ability of the largest pension funds to overcome barriers to collective action internally is a crucially important feature.[35]

[34] Given the enormous financial assets of insurance companies, these holdings are still very large in real terms.

[35] In the United States, a group of shareholders who act together on a voting issue and together own 5% of a company's shares must file a Form 13D with the SEC, and risk a lawsuit by the company or by

Figure II.1



other shareholders claiming incomplete disclosure of their plans (Black 1998). Even these restrictions are considerably less onerous than those that existed prior to 1992 reform. Similar restrictions exist in other countries.

Figure II.2

	Pension Fund/Sponsor	Country	Total Assets as of 12/ 31/ 2007 (in $ millions)
1	**Government Pension Investment**	Japan	$1,072,429.00
2	**Government Pension**	Norway	$370,985.00
3	**ABP**	Netherlands	$314,969.00
4	**California Public Employees**	U.S.	$254,627.00
5	**National Pension1**	Korea	$231,966.00
6	**Federal Retirement Thrift**	U.S.	$223,338.00
7	**California State Teachers**	U.S.	$176,270.00
8	**New York State Common**	U.S.	$164,363.00
9	**Local Government Officials2**	Japan	$144,447.00
10	**Florida State Board**	U.S.	$142,519.00
11	**General Motors**	U.S.	$133,835.00
12	**New York City Retirement**	U.S.	$130,328.00
13	**Postal Savings Fund**	Taiwan	$129,397.00
14	**PFZW**	Netherlands	$128,615.00
15	**Canada Pension3**	Canada	$123,903.00
16	**AT&T**	U.S.	$117,537.00
17	**Texas Teachers**	U.S.	$114,878.00
18	**Pension Fund Association2**	Japan	$112,698.00
19	**Ontario Teachers**	Canada	$110,600.00
20	**New York State Teachers**	U.S.	$106,042.00
21	**GEPF**	South Africa	$103,644.00
22	**Central Provident Fund**	Singapore	$94,964.00
23	**Employees Provident Fund**	Malaysia	$94,659.00
24	**Wisconsin Investment Board**		$91,615.00
25	**General Electric**	U.S.	$88,237.00

notes: 1Estimate; 2March 31, 2007; 3March 31, 2008
source: Pensions & Investment

Pension Funds in the Firm

There is a long standing expectation among academics that pension funds will play a key role in corporate governance by using their equity stakes as a vehicle for monitoring management in the firms they invest in. In the law literature, Coffee (1991) and Gilson and Kraakman (1991) both note the unique position of institutional investors and suggest reforms that would further increase their efficacy in corporate governance matters. Black (1990, 1991) suggests that pension funds, particularly public pension funds, are uniquely advantaged in their size and independence to play an important pro-shareholder role. In the political science literature, Goyer (2006) argues that Anglo-American pension funds, because of their typically long-term investment horizons, often improve the corporate governance of the firms they invest in.

Economists have been equally enthusiastic in their hope that pension funds will play a strong role in corporate governance. Grossman and Hart (1980) , Shleifer and Vishny (1986), Huddart (1993), Admati et al. (1994) and Noe (2002) all suggest an important role for large shareholders as agents of better corporate governance through firm-level monitoring. Del Guercio, and Hawkins (1999) and Gillan and Starks (2000), Smith (1996), English, Smythe and McNeil (2004), Nelson and Weisbach (1998) and Barber (2007), among others, all find empirical evidence that various forms of pension fund activism has a positive impact on corporate management and/or the value of the portfolio held by the activist investor. Others, including Black (1998), Wahal (1996), Romano (1993) and Murphy and and Van Nuys (1994) are more skeptical.

Public Pension Funds And The Policy Process

A second potential channel of influence for pension funds is through the policy process. Indeed, it is this possibility that is explicit in the theoretical model in chapter 3. As with pensions funds' role in firm management and firm level corporate governance, many prominent theories postulate a role for pension funds in the policy process. Among political scientists, Gourevitch and Shinn (2005) and Gourevitch (2007) argue that pension funds play a key role as an interest group representing investor interests in policy debates, particularly when they hold a significant portion of corporate equity in their portfolios. Among economists, Pagano and Volpin (2001, 2005) and Bebchuk and Neeman (forthcoming) each present formal models that rely on strong lobbying efforts by institutional investors. Gourevitch and Shinn (2005), Iglesias (1999), Walker and Lefort (2001), Catalan (2006), Hebb and Wojcik (2005), Jacoby (2007) and others provide qualitative evidence to support a strong role for pension funds as policy shapers around the globe. Other analysts take the opposite view (Perotti and Volpin 2007, Culpepper (forthcoming), Roe (1994)).

The empirical record of pension fund activism in the policy arena is decidedly more mixed than theoretical expectations would suggest. Some pension funds are extremely active within firms and in the policy process, others less so, if at all. Such discrepancies pose serious puzzles for analysts. Why are pension funds, supposedly the savior of the shareholder rights movement, so varied in their actual behavior? Catalan

(2004), in his analysis of Chilean pension funds poses four questions that analysts must answer to fully understand the role of pensions in corporate governance. They are: "1) We need to formulate more precise hypotheses and find more conclusive evidence regarding the link between pension fund and stock market development, and filter the corporate governance channel from the liquidity and transaction cost reduction channels; 2) We need to know whether pension funds actually play an active and direct role in the enactment of pro-investor laws, or whether such laws are natural follow-ups on pension reforms that are enacted under the pressure of other groups such as labor unions; 3) We need to study the link between pension funds, the ownership structures of publicly traded firms, and public firms' performance; 4) We need to address seriously the question "Do pension funds act in the best interest of pensioners?" (31).

Questions 1 and 3 are better answered by economists, I do not attempt to do so in this dissertation. Instead I address questions 2 and 4, though I pose the questions differently. I ask: *Why do some pension funds but not others play an active and direct role in the enactment of pro-investor laws?* and 2) *Why do some pension funds but not others act in the best interests of their pensioners?*

Section II of this dissertation explores the role of pension funds in corporate governance issues in two countries: The United States and Poland. Chapter 5 examines the political activities of US-state-based public employee retirement systems, with particular attention paid to their activities during the 1980s and early 1990s when a wave of hostile takeovers and an ensuing wave of anti-takeover rules gave the post-ERISA US pension system its

first real political test. Chapter 6 examines the political behavior of pension funds created in the wake of pension system privatization in Poland and their role in developing the corporate governance rules from 2002-2008.

My primary findings in this section accords very well with my expectations. In order to play a meaningful role in corporate governance pension funds need to overcome barriers to collective action. In the US case, only the pension funds with large enough equity holdings that the broadly diffused gains from pension fund activism accrue to the activist fund in sufficient quantity as to offset the cost engage in corporate governance activism. Accordingly, I find that the spread of anti-takeover laws across US states can be explained quite well by the size of the equity holdings of state based pension funds.

More importantly, I find that the ability to overcome collective action problems is a necessary, but insufficient, condition. Polish pension funds are far more organized than their American counterparts, and the largest of them own a considerably larger portion of the Polish stock market than the largest American funds do of the American stock market. However, corporate governance activism by Polish pension funds is virtually non-existent. The key difference is the regulation induced competitive pressures and herd behavior that disincentivizes Polish pension funds from engaging in the sort of corporate governance activism that is undertaken by some of the American pension funds.

Chapter 5 – State Public Employee Retirement Systems and Anti-Takeover Laws

> You own the company. That's right -- you, the stockholder. And you are all being royally screwed over by these, these bureaucrats, with their steak lunches, their hunting and fishing trips, their corporate jets and golden parachutes.
>
> Gordon Gekko, Address to Teldar Paper Stockholders, *Wall Street* 1987
>
> There is the instrument of our destruction. I want you to look at him in all of his glory, Larry "The Liquidator," the entrepreneur of post-industrial America, playing God with other people's money. The Robber Barons of old at least left something tangible in their wake -- a coal mine, a railroad, banks. This man leaves nothing. He creates nothing. He builds nothing. He runs nothing. And in his wake lies nothing but a blizzard of paper to cover the pain. Oh, if he said, "I know how to run your business better than you," that would be something worth talking about. But he's not saying that. He's saying, "I'm going to kill you because at this particular moment in time, you're worth more dead than alive."
>
> Andrew Jorgenson , Address to New England Wire & Cable Co Stockholders. *Other People's Money* 1991

The 1980s were a wild time in American corporate governance. At the core of this wildness was the increased use of "hostile takeovers". In a hostile takeover, a bidder locates a target firm and buys out enough shareholders to take control in the hopes of reselling the company in a more profitable form, either by improving corporate performance by replacing management and/or the board of directors, or by selling the constituent parts of the firm for more than the whole was worth. The transaction is hostile because the bidder bypasses management and the board of directors, and instead goes straight to shareholders.[36] There were a lot of corporate takeovers during the 1980s. Fully 28% of the fortune 500 companies in 1980 had been acquired by 1989 (Shleifer and Vishny 1991). Among the targets are some of the icons of American industry: TWA, RJR Nabisco, Texaco and Phillips Petroleum. Notable corporate raiders such as Kohlberg Kravis Roberts & Co (KKR), Carl Icahn, T. Boone Pickens, and the Bass Brothers

[36] Otherwise, it would be a "friendly takeover".

became household names and the new face of shareholder activism, replacing the gadfly investors such as the Gilbert Brothers and Evelyn Y. Davis.

Two events in particular precipitated the hostile takeovers of the 1980s. The first was a financial innovation made by Drexel Burnham Lambert, then under the guidance of Michael Milken. Milken perfected the art of issuing high yield debt – junk bonds – to finance corporate raiders. Drexel would issue the junk bonds (which were often bought by pension funds, who made a bundle off of them during the 1980s) with future revenue streams tied to the bidders' ability to sell the target for more than they bought it for. The second precipitating event was legal change. Prior to 1982, hostile takeovers were rare in large part because state-level corporate law made the transactions cumbersome and expensive, through what are now called first -generation antitakeover laws. These laws were struck down by *Edgar v. MITE Corp.(1982)* which ruled that first-generation antitakeover laws violated the Williams Act (1968), which regulates takeovers at the federal level. Suddenly the managers and directors of American firms were exposed to raiders.

Movies like “Wall Street” and “Other People's Money” sought to demonstrate the recklessness of the hostile takeover era. As the opposing epigraphs make clear, different people had different perspectives on the value of hostile takeovers. For some, the rise of the hostile takeover signaled the end of corporate under-performance, as the managers of American companies suddenly faced an active market for corporate control that could keep them disciplined. If a stock price sunk too far below what it “should” be, firms suddenly became potential targets, and their managers and directors faced potential

dismissal. The result was more reinvestment in productive capital, cost-cutting layoffs and fewer corporate hunting and fishing trips. For others, the leveraged buyout craze was the end of a kinder, gentler sort of firm that could afford to depress stock prices – at least temporarily - in the name of supporting employees, suppliers, local communities and other stakeholders. For others, hostile takeovers were simply a bad idea, particularly in R&D dependent industries, forcing companies to focus on short term stock price at the expense of long term growth.

Following *Edgar,* states began to rebuild their anti-takeover laws in different guises; first as second-generation antitakeover laws and, following *Dynamics Corporation v CTS Corporation (1987),* as third generation anti-takeover laws. By the early-1990s states had more or less larded up on anti-takeover statutes, Milken was in jail for securities fraud, Drexel Burnham Lambert had declared bankruptcy and the economy was in recession. The hostile takeover market effectively died.

Whether or not the United States as whole is better off for having gone through the hostile takeover craze of the 1980s is a topic for another forum. What is important for this chapter of my dissertation is how the hostile takeover era impacted shareholders, and what pension funds did about it. Hostile takeovers and the anti-takeover laws that followed had profound consequences for shareholders. One one hand, hostile takeovers had their anticipated effect on American managers. The efficacy of corporate management improved markedly over this period (Rappaport 1990). In this sense, the advent of the active takeover market was an enormous boon to shareholders across the country. Even in the absence of a long term impact on managerial quality, shareholders

that were bought out by raiders were often bought out at a significant premium to market prices and profited handsomely. One the other hand, the tactics employed by takeover artists often abused shareholder interests. One common abuse was greenmailing, in which management would buy out a potential raider at a premium, effectively robbing shareholders in order to preserve management jobs. Also common were two-tiered or freeze-out bids, in which raiders would structure their offer to induce nervous shareholders to sell their shares to bidders at an inadvisedly low price.

Pension funds had a clear interest in preserving the takeover market, but curtailing its abuses. This was true at the policy level, by encouraging a pro-shareholder legal environment in the states, and at the firm level, by pressuring firms to rid their corporate charters of poison pills and other antitakeover devices that were typically allowed, but not mandated by state corporate law. Despite this interest, not every pension funds got involved in corporate activism at either the firm or the policy level. In fact, only a handful of pension funds out of hundreds across the country engaged in any sort of meaningful corporate governance activism..

Before examining pension activity during the hostile takeover era I first describe the evolution of American corporate governance and the position of pension funds in American corporate finance and American corporate governance.

5.1 Corporate Ownership in the United States

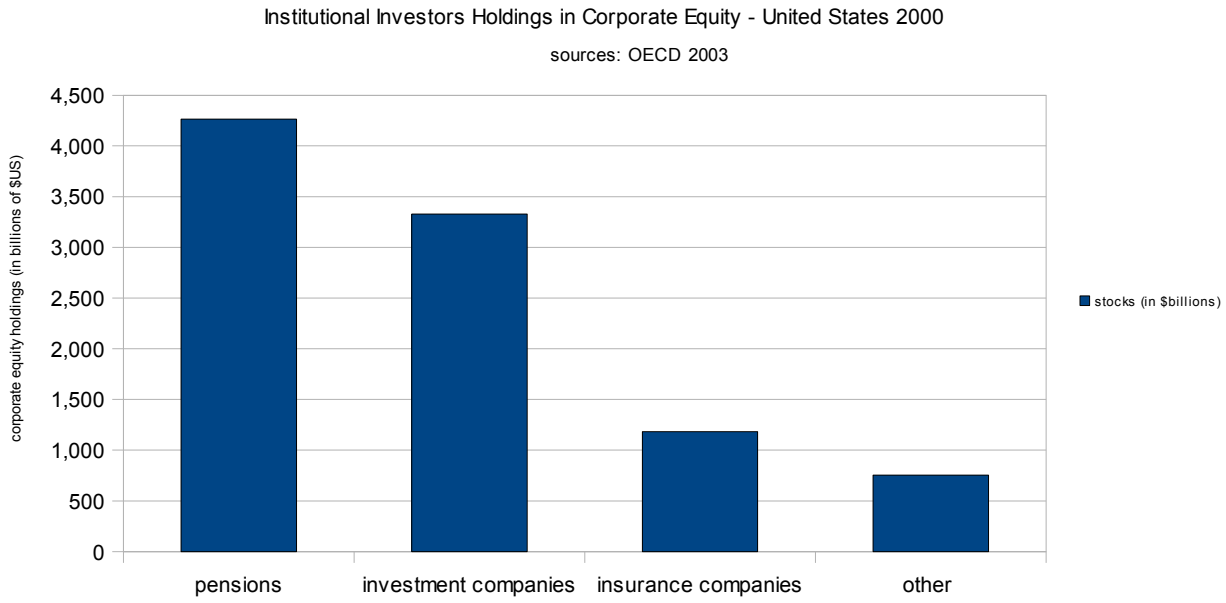
Pension funds have become the dominant vehicle for financial intermediation in the

United States. Figure 5.1 shows the assets of the major institutional owners of shares in the United States in 2000. Pension funds held over 4 trillion in equity holdings in 2000, more than any other class of institutional investors and dwarfing the $700 million of equity that pension funds owned in 1945 (Gourevitch and Shinn 2005). The accumulation of American savings into pension funds, and the expansion of corporate equity in pension funds portfolios over the last 30 years has completely redefined corporate ownership and corporate governance in the United States. Drucker (1976) famously suggested that the United States was entering a new period of "pension fund socialism", in which workers owned the means of production through their pension fund equity stakes. While Drucker's fears of impending socialism may be in some senses over-wrought, it may also be understating the case. By 2007 the aggregate portfolio of American state and local public employee retirement systems had 36.46% of their assets invested in corporate stocks, totaling over $1.2 trillion in assets (US Census 2007). Add to that the massive holding of the Federal Employee Retirement System (FERS) and it becomes clear that it is not just the workers that own corporate America, but government workers. How did we get here?

5.1.1 Pension Funds, The Money Flood and The Four Stages of American Capitalism

Clark (1981) famously and succinctly summarized American financial history as a sequence of four stages. The first stage of American financial history was marked by the 19th century robber barons. During this stage, tycoons such as John D. Rockefeller

Figure 5.1


Institutional Investors Holdings in Corporate Equity - United States 2000
sources: OECD 2003
corporate equity holdings (in billions of $US)
4,500
4,000
3,500
3,000
2,500
2,000
1,500
1,000
500
0
pensions
investment companies
insurance companies
other
stocks (in $billions)

(Standard Oil), JP Morgan (US Steel), and Cornelious Vanderbilt (railroads) served as both managers and owners of some of America's largest corporations. This period oversaw the creation of some of America's most enduring and influential firms. It also created a caste of extraordinarily wealthy financiers/managers whose near monopoly of investment finance gave them effective veto power over the country's entrepreneurial ambitions. Corporate governance was not an issue during the first stage of American capitalism, as the owners had more or less direct control over the managers. Accordingly, there was little need to develop legal mechanisms to make management more accountable to capital. Rather, the primary concern was keeping these large corporations beholden to the public interest in national economic efficiency. In this light, the Sherman Antitrust Act (1890) and Clayton Antitrust Act (1914) can be seen as corporate governance reforms suited to the nature of corporate ownership of the day.

The push-back against the financier/managers was widespread and finally came to a head during the Great Depression, when, as Franklin Roosevelt put it, "the money changers were cast down from their high place in the temple of our civilization." This casting down was achieved through a variety of new capital market regulations including Glass-Steagall (1933). These reforms effectively severed the connection between management and finance and commercial from investment banking and thereby allowed for the creation of a system of ownership characterized by Berle and Means. In this second stage of capitalism, which was ascendant through the 1960s, professional managers were separated from the financiers, who were an increasingly disparate set of

small shareholders, without much ability to hold management accountable for their actions. As a result, the American legal system at this time became increasingly conscious of the vulnerability of shareholder capital, and sought to affirm the manager's legal role as a fiduciary. These legal innovations were primarily aimed at corporate disclosure and laws the facilitated capital market operations. The underlying philosophy was that "efficient" or "fair" capital markets supplied with accurate and timely assessments of firm performance could serve as an appropriate check on management to the extent that under-performing firms would find it harder and more expensive to raise new capital (Clark 1981).

Pension funds were an non-factor in American corporate governance through the first two stages of American financial capitalism. The first modern American pension fund was established in 1875 by the American Express Company, which at the time operated an express delivery and railroad operation (O'Barr, Conley and Brancato 1992). This and other early pension plans were quite limited; the American Express Company pension only vested if former employees were 1) permanently incapacitated, 2) at least 60 years old, 3) had worked for the company for more than 20 years and 4) had their pension plans approved by management, which was done on a case by case basis. The pension, if it was received at all, amounted to ½ average annual earnings over the 10 year period prior to retirement (O'Barr, Conley and Brancato 1992).

Corporate pensions spread throughout the railroad industry and, in 1901, US Steel became the first major manufacturing firm to establish one. By 1930, industrial pension plans had spread to firms employing 10% of the non-agricultural working population.

Unions followed suit, offering retirement benefits for some of their members (O'Barr, Conley and Brancato 1992). These early retirement plans were unfunded, which is to say that the assets used to pay retirement pensions came from general revenues, rather than from a dedicated trust. When the sponsoring firm ran out of money, so did the pension plan and benefits were not paid. Many of the nominally funded plans were invested in the sponsoring firms bonds which effectively meant that the firm was lending itself money to finance the pension plans (Sass 1997). The Great Depression wiped out many of these early pension systems (Clowes 2000).

Retirement systems for public employees developed at the same time as the private pension funds. The first public employee pension plan was devised in 1857 to serve New York City Police Officers. In 1920 the federal government began operating the Civil Service Retirement System, which covered federal employees.[37] The first state-level retirement systems meant to cover public employees as a whole were introduced during the 1920s in New York, Massachusetts and New Jersey (Tilove 1976). State level plans covering the retirement of public employees would soon spread across the nation. Only 2% of state retirement system funds were invested in corporate stocks as recently as 1960 (Tilove 1976). Clowes (2000) attributes much of this conservatism to state legislators, who were more fearful of losses in the stock market than they were of not achieving gains. The heavy tilt of pubic fund assets towards treasuries and other fixed-income debt securities left these funds wildly exposed to inflationary losses, but such losses were not seen to be as politically salient as losses related to dips in the stock

[37] The Civil Service Retirement System would later be transformed into the Federal Employee Retirement System (FERS), which is currently the largest pension fund in the United States, though the voting rights of held equity are allocated to Wells Fargo, which manages the fund, making the federal government a non-entity in corporate governance matters, as was the intention.

market.

The third stage of American capitalism marks the rise of institutional investors - particularly pension funds – as the primary means of stock ownership. The rise of these institutional investors created a large class of immensely powerful asset managers with the theoretical ability to overcome barriers to collective action that all but prohibited individual shareholders from holding managers accountable during the second stage. Much of what ushered in the third stage of American capitalism and the dramatic rise in pension fund assets was a 1948 ruling by the National Labor Relations Board (NLRB) in a dispute between the United Steel Workers Union and Inland Steel. The NLRB's decision ruled that employee pensions were an appropriate issue to be included in collective bargaining agreements. Unions negotiators became increasingly interested in pension plans and insistent that these plans be fully funded and that they cover blue collar workers (extant plans were typically limited to white collar workers) (Clowes 2000). In 1950 the UAW negotiated a fully funded pension plan with General Motors, the first of its kind in a major industrial firm, and the first of its kind to be invested in a diversified portfolio with substantial equity (O'Barr, Conley and Brancato 1992). At the same time, some public fund executives began pushing for greater levels of stock ownership in the public employee retirement funds, led by Ray Lillywhite of the Utah State Teachers Retirement system and later of the Ohio State Teachers Retirement System.

Lillywhite's efforts to encourage pension funds to hold more corporate equity was buoyed considerably by contemporary academia. In 1959 Harry Markowitz published his dissertation, which was the first to note that portfolio risk could be minimized by

investing in stocks with low covariance. In 1964 William Sharpe, working with Markowitz as his dissertation chair, developed a simpler application of Markowitz's theory, which enables investors to base their portfolio management decisions on the correlation of individual stocks to the market as whole, rather than the correlations between individual stocks. Sharpe's and Markowitz's work became the basis for the Capital Asset Pricing Model (CAPM), which would earn them both Nobel prizes in 1990 for their contributions to "Modern Portfolio Theory."

At the same time that Modern Portfolio Theory was being developed, Eugene Fama at the University of Chicago was developing the Efficient Market Hypothesis (EFH). Effectively, EFH says that in the long run, an investor cannot beat the market. For a portfolio meant to perform in the long run, such as those managed by pension funds, there is therefore no need to hire expensive, outside money managers. Long term returns can be improved by managing a portfolio to mirror the market, or some slice of the market such as the S&P 500, and cutting out the expensive transaction fees associated with an actively managed portfolio. EFH inspired passive investment strategies that are widely in use among pension fund managers. Collectively, the corpus of work on CAPM and EFH suggests that investing in the stock market need not be like gambling at the casino. Suddenly there were methods to build a portfolio whose returns were more predictable, safer for investors and could be implemented with minimal cost through passive indexing. (Clowes 2000). Public pension funds across the country took notice. Pension fund investments in corporate equity swelled to 21.8% of assets by 1973 (Tilove 1976).

The fourth stage of American capitalism is defined by the movement towards legal protections for fund beneficiaries and an increased fiduciary duty on the part of fund managers. It is the fourth movement that set the stage for pension fund activism around corporate governance issues. Following the collapse of Studebaker and the resulting denial of pension benefits to its employees, union officials and retirees were reminded of the risk for retiree benefits in unfunded or insufficiently funded pension plans. The federal government once again became involved in the pension business, this time to give statutory weight to the notion of pension funding.

The resulting bill was the Employee Retirement Income Security act of 1974 (ERISA). ERISA is a complex and broad piece of legislation, and I will not attempt to do justice to all of its components. Of the three points most pertinent to this dissertation, in order to remain eligible for the preferential tax treatment of pension benefits ERISA 1) required firms to fund their unfunded past service liabilities over 30 years, 2) was widely interpreted as mandating diversification across asset classes[38] and 3) held funds managers legally liable as a fiduciary on behalf of plan beneficiaries, unless such duty was delegated out to an external funds manager, in which case that manager became the legal fiduciary. Internally managed funds could no longer invest heavily in the equity of their own company without risking legal action for violating fiduciary duty (Enron employees have been issued over $450 million of damages stemming from ERISA violations in the Enron pension plan). While ERISA technically applies only to private pension, most public pensions have adopted its standards.[39] The result of these reforms was to unleash

[38] This understanding was validated in a 1989 interpretive bulletin by the department of Labor (Clowes 2000)

[39] Public pension plans are subject to the "prudent man" rule, which is to say that they have a fiduciary duty to invest prudently. This has been widely interpreted as tantamount to ERISA.

another flood of money into the equity portfolios of pension plans.

Clark, writing in 1981, only saw the first four stages of American finance. Clark and Hebb (2004) argue that we have now entered a fifth stage of capitalism, in which pension funds play an increasingly active role in the management of the firms that they have invested in. Clark and Hebb point to the so-called "Avon Letter", issued by the Labor Department' in 1988 as the watershed moment in the transition from fourth to fifth stage American capitalism. The Avon letter clarified the fiduciary duty of ERISA pension fund managers to include voting proxies with the same diligence with which they make other fiduciary decisions. Suddenly, the designated fiduciaries *had* to support pro-shareholder resolutions as a matter of law (Clowes 2000).

Important as the Avon letter was, by the time it as issued the change in the corporate governance stance of American pension funds was already underway. The roots of pension fund activism on mass scale go back to former CalPERS chairmen Jessie Unruh. Jessie Unruh, known in California political circles as "Big Daddy", loomed large over the California Democratic Party, serving first as a state assemblyman and then speaker of the Assembly, where he engineered the creation of a full time legislature. After losing elections for governor of California and mayor of Los Angeles, Unruh was elected to be State Treasurer, a position he held until his death in 1987. Unruh became known for his unusually hands one approach, traveling to Wall Street to personally oversee California bond issues (Putnam 2005). As Treasurer, Unruh was given a seat on the board of the two largest California pension funds, CalPERS and CalSTRS. Unruh's corporate governance epiphany came in 1984, when the Bass Brothers, well known

corporate raiders, successfully greenmailed Texaco. In this case the Bass Brothers were paid a premium of $137 million, which was roughly a 57% premium on market price of their 9.9% stake in the company. The winners in this transaction, as in all greenmailing, were the potential raiders, who were now $137 million richer, and management, who still had a job. The losers were the shareholders, including CalPERS. Unruh was apoplectic. He initially tried to block the payment to the Bass Brothers, but failed. He then demanded that Richard Koppes, CalPERS' General Counsel at the time, "start a f****** shareholders rights movement."[40]

Unruh's first move was the creation of the Council of Institutional Investors (CII), which would, in theory, act as a centralized voice for pension funds across the country. The potential for CII to have a considerable impact was not lost on the financial industry, leading Kenneth Miller, then Vice Chairman of Merrill Lynch to observe that "if the institutions start speaking with one voice, they could become a financial OPEC." (Putnam 2005: 403). CII never became a financial OPEC, but it did work with pension funds and other institutional investors to coordinate their activism activities. Of particular concern at the time was the mass adoption of poison pills – a commonly adopted antitakeover device in which insiders can issue new stock to friendly shareholders as a way of diluting the voting rights of potential raiders. In 1984 virtually no manufacturing firm had a poison pill provision in its corporate charter, while over 60% did by 1989 (Useem 1998:51).

Early efforts to remove poison pills from corporate charters were unsuccessful, with most firms retaining anti-takeover devices in their corporate charter. At the end of

[40] Interview conducted by author with Richard Koppes on 4/22/2009

the 1987 proxy season the scorecard read: Poison Pills: 31, Institutional Investors:0 (Rosenberg 1999). The biggest hurdle was convincing the institutional money managers to vote against management when those same money managers had side businesses with management. In this sense pension fund's money mangers were subject to the same conflicts of interests that have traditionally kept mutual funds and insurance companies from playing a significant pro-shareholder role in corporate governance. The big break came in 1987 with the issuance of the Avon Letter.

5.2 Firm Level Pension Fund Activism

There are two flavors of pension fund activism at the firm level: CalPERS during the late 1980s and early 1990s, and everything else. CalPERS' early efforts at the firm level activism were led by led by Richard Koppes and CEO Dale Hansen, and were defined by a conviction that taking CalPERS' pro-shareholder mission to the press and building allies in the public arena was a key component of ensuring that CalPERS would be able to hold firms accountable. CalPERS initial foray into corporate governance relied on so called "name and shame" practices. Originally CalPERS targeted firms for poor corporate governance records, though it quickly learned that it is hard to provoke reform in a firm that is also recording profit (Smith 1996). Building on this insight, CalPERS began its "Failing Fifty" campaign, in which it would select fifty of the worst performing companies that CalPERS had also deemed to have poor corporate governance practices and target their shareholder meetings with resolutions seeking to strike down various

practices thought to be unfriendly to shareholders. However, the real thrust of the Failing Fifty campaign was in the media rather than in the boardroom. Targeted companies would be publicized, as would calls for specific officers to step down.

Unsurprisingly, there was considerable push back in the business community to CalPERS' public efforts. Managers did not want CalPERS or any other investor calling their compensation schemes, antitakeover devices or other practices into question. CalPERS' reputation as an activist investor had grown to the point where managers across the country were vocalizing their displeasure. Acting partly on their behalf, in 1991 then Governor of California Pete Wilson attempted to de-claw CalPERS by tapping CalPERS' funds to make up state budget shortfalls and replacing CalPERS' 13-member board, four of which were Governor appointed, with a new nine-member board, five of whose members would be appointed by the Governor. (Stevenson 1991). CalPERS bristled, naturally, and saw this as an assault on their independence and corporate governance activities. Wilson's efforts were stymied, barely, in 1992 by the narrow passage of proposition 162, which gave CalPERS board members complete authority over the use of its assets, and prohibited changes to the composition of the CalPERS board without prior approval.

While victorious in its battle with Wilson, the ordeal of proposition 162 led CalPERS to dial back its public strategy (Jacoby 2007). In 1992 CalPERS “Failing Fifty” efforts had transformed into a more modest and less confrontational “Focus List” of under-performing firms, though even this less confrontational approach was still considerably more confrontational than any other major pension fund. Following the

departure of Koppes (1996) and Hansen (1994), CalPERS continued its less public but nonetheless active role as the countries largest activist investor.

In its more recent manifestations CalPERS activism is quite similar to techniques traditionally used by activist institutional investors such as TIAA-CREF, SWIB, NYCERS and others. The traditional means of activism is simply to file proxy resolutions in the shareholders' meetings of targeted firms. This strategy gained a considerable amount of momentum when, in 1992, the SEC revised rules that formerly required SEC approval on shareholder resolutions. Suddenly activism became much cheaper. More recent strategies include “Vote No” campaigns meant to undermine directors that are unpopular with institutional investors (Del Guercio, Wallis and Woidtke 2006). The most successful strategies however, have taken place out of the public eye. Most funds prefer to settle their differences privately with management, agreeing to withdraw proxy resolutions if management agrees to enough of its demands. Even the once boisterous CalPERS has now adopted this strategy. In 2009 CalPERS' Focus List identified 13 firms with poor corporate governance features and low returns on capital, and met with them privately to address CalPERS concerns. Most of the firms complied with CalPERS requests sufficiently to avoid bad publicity, and only 4 firms were eventually named to the public. In accordance with this stance, George Diehr, CalPERS Investment Committee Chair noted that "Placing these companies on the Focus List and bringing share owner resolutions against them in some cases are last resorts for us" (CalPERS 2009).

5.2.1 Does Firm Level Shareholder Activism Work?

The effectiveness of shareholder activism is notoriously difficult to gauge, and empirical studies have given conflicting results. Del Guercio, and Hawkins (1999) and Gillan and Stark (2000) both find that pension fund sponsored proposals garner more votes than individual initiated proposals. Carleton, Nelson and Weisbach (1998) find that targets of TIAA-CREF requests typically resolve these issues privately, usually with outcomes that strengthen corporate governance regimes. Huson (1997) and English, Smythe and McNeil (2004) all find evidence of a "CalPERS effect", wherein the targeting of management by CalPERS leads to an increase in stock price. Anson et al. (2004) find a significant long term impact on stock prices following a CalPERS targeting. CalPERS certainly thinks their efforts have been rewarded, and often cites commissioned studies by Wilshire and Associates with conclusions to that effect. Barber (2007) estimates that CalPERS activism has led to short term increase in value(for the market as whole, not just CalPERS) of $3.1 Billion from 1992 -2005. Smith (1996) estimates that the short terms gains to CalPERS from their activism to be $18,880,817 over seven years (1987-1993) more than justifying CalPERS expense, reported to be $500,000 annually.

Other authors have found different results. Wahal (1996) and Del Guercio and Hawkins, for example, finds no long term impact on stock price following a CalPERS intervention. All of these studies almost certainly underestimate the impact of pension fund lobbying in the firm because 1) such lobbying often takes place in private and is resolved by management to the pension funds satisfaction in order to keep it out of the

public eye, 2) the threat of future intervention by pension fund activists likely keeps managers of firms with large institutional ownership more sensitive to shareholder rights even in the absence of any explicit activism, and 3) the publicization of pension fund activism, such as the release of the Focus List, signals to investors not only that a fund will be pushing for better corporate governance (which sends a positive signal about future earnings) but also that the management of the firm was unwilling to accommodate the pension fund in private (which sends a negative signal about future earnings) (Barber 2007).

5.2.2 Limitations on Public Fund Activism

The most important limitation on pension fund activism is size. In practice, only the largest public pension funds have participated in corporate governance activism in any meaningful way. There is good reason for this. If we take Smith's estimates of CalPERS gains from activism as a guide, a $3.5 million investment in corporate governance activism yields a return of roughly $19 million, assuming the activist firm is able to reap the benefits of their own activism to the same extent that CalPERS is. This is, of course, not the case for most pension funds, which have significantly smaller holdings than CalPERS, and are therefore less able to benefit from their corporate governance activities. If a firm had exactly half of the holdings as CalPERS in an identical portfolio, the $3.5 million investment would have only yielded $9.5 million in returns. A pension would break even on their investment if it held an equity portfolio that

is roughly 18% the size of CalPERS'. In practice, few pensions funds are that big. In fact, at the beginning of the takeover era in the 1981, only 17 of the 146 state sponsored pension funds had equity holdings greater than or equal to 18% of CalPERS' holdings. This group effectively contains every major activist investor in the country, including CalPERS, CalSTRS, New York Common, SWIB, Pennsylvania State Retirement System and Ohio Teachers Retirement System. Of course, the above calculation is rough, at best. Moreover, there is almost certainly an economy of scale involved in corporate activism, suggesting that corporate activism is economically reasonable for an even smaller slice of the state pension funds. In any case, however, it is no accident that only the very largest funds find it in their interest to engage in corporate governance activism in the firms they invest in.

The second limitation is that, while public pension funds lack the commercial conflicts of interest faced by other institutional investors, they are, ultimately, state run bodies, and are typically accountable to state government, as well as to subscribers. Certainly, much of the “socially responsible” investment activity of late has been driven by political rather than financial motives. Occasionally these political pressures can stop pension fund activism in corporate governance matters. General Motors' relationship with its investors stands as a case in point.

When Roger Smith - later made famous as “Roger” from Michael Moore's film “Roger And Me” - took over as chairmen of GM in 1981, the company was coming off of its first annual loss since the 1920s. Over the course of Smith's tenure, which lasted until 1990, GM continued its downward slide, with accelerating layoffs and diminishing

US market share that eventually reached 35%, down from over 50% in the 1960s (Greenwald et al. 1992). As part of Smith's efforts to shake up GM's business model he acquired Electronic Data Systems (EDS), a young, tech-savvy data processing firm with seemingly limitless growth potential. According to the terms of the acquisition, EDS' CEO, Ross Perot, became the single largest individual shareholder in GM. The marriage between the stodgy GM, with its tradition bound practices of managerial wage setting and promotion and the upstart EDS, which favored performance based incentive structures, turned out to be far more tumultuous than Smith had expected (Monks and Minow 2004). Perot began to bristle at what he saw to be GM's poor management, and became an increasingly active dissident voice within the firm and in the media. Rather than contend with an increasingly public critic in Perot, Smith simply bought out Perot's shares in EDS (with company money, of course), for an extraordinary $742.8 million, a premium of almost 100% over market value.

Naturally, other large shareholders were outraged, including the State of Wisconsin Investment Board (SWIB), which by that time had become one of the largest pension funds in the country. SWIB requested that the buyout be rescinded, and threatened shareholder resolutions or a lawsuit to force GM's hand. But Smith was no happier with SWIB's activism than with Perot's. Smith called the Governor of Wisconsin and threatened to scuttle plans for a new GM plant in Wisconsin if SWIB didn't back off their criticism of the Perot buyout. The Governor of Wisconsin did not back up its fund, and SWIB capitulated (Monks and Minow 2004). The buyout proceeded as planned, to the great detriment of GM shareholders.

This episode deservedly earned GM and Smith a reputation for shareholder unfriendliness. By the time Smith was to step down, the consensus among many large shareholders, including CalPERS, was that the tradition of orderly succession of the chairmanship from one GM insider to another had to change. In 1990, Dale Hansen wrote to GM to inquire about GM's succession plan following Roger Smith's departure, and added that CalPERS would press for Smith to not be named to the GM board of directors following his departure, which was customary practice until then (Monks and Minow 2004). Smith was again furious at the nerve of the activist funds, and again personally called the Governor of California, George Deukmejian, to order CalPERS to cease their agitation, even going so far as to threaten to close down the GM plant in Fremont CA, the only such GM facility in the state.[41] Deukmejian balked at GM and backed up Hansen and the team at CalPERS, who would eventually submit an (unsuccessful) resolution against retaining Smith as a board member.

Why was CalPERS politically insulated where SWIB was not? It could be that California is simply so large a state that the loss of the Fremont plant would have been more a drop in the bucket than the potential loss of the GM facility in Wisconsin. It could be that the threat, which was never carried out, was not credible, given the productivity of the Fremont plant. It is also possible that CalPERS' public efforts had helped it build political allies in the public and in the state legislature, that SWIB's more private activism had not. I will refrain from speculating further as to the reasons, but it remains clear that political independence enjoyed by CalPERS gave it considerably more room to maneuver. Even among the activist pensions noted above, it is no accident that

[41] Interview with Richard Koppes

the California based funds and New York based funds, which are overseen entirely by an independently elected office, the state comptroller, as opposed to the legislature or governor, account for the vast majority of public pension originated shareholder proposals, with TIAA-CREF, which lacks responsibility to any state or commercial interests, not far behind (Gillan and Starks 2000).

5.3 Pension Funds' Policy Implications

Pension funds have also been active and consequential in corporate governance policy matters. At the federal level, the most notable undertaking of this period involved reforms of proxy rules, allowing pensions to submit proposals directly to shareholder meetings without getting prior approval by the SEC, and loosening restrictions on communication between major shareholders. This policy change involved lobbying the SEC rather than the legislature, and, while important, the politics of regulatory agencies is somewhat outside of the purview of this dissertation. In the legislative arena, most elements of corporate law have been traditionally decided at the state level. Thus the remainder of this chapter is focused on state law.

5.3.1 Anti- Takeover Laws

Anti-takeover laws were a reaction to the leveraged buyout crazed 1980s noted at the beginning of this chapter. Besides simply paying off would-be takeover artists through

greenmailing, the simplest way for management to protect themselves from hostile takeovers is to adopt some form of an antitakeover provision in its corporate charter. These provision can take a myriad of forms, with popular ones including staggered boards, poison pills, business combination provisions, and control share acquisition provisions. Unsurprisingly, these provisions are quite popular with management, and a the source of much consternation for shareholders. As noted above, much of pension fund's activism at the firm level has sought to rid corporate charters of these provisions.

While the decision to adopt an anti-takeover into a corporate charter (or to employ it in the event of a tender offer) is typically a firm level decision, the latitude given to corporate managers and directors is very much a function of state law. Through the 1960s and 1970s many state legislatures effectively shielded managers from hostile takeovers by enacting so-called first generation anti-takeover laws, which typically required the bidder to file with the state, wait before carrying through the offer and occasionally gave state administrators the authority to block a takeover on grounds of fairness to state residents (Vogus and Davis 2005; Roe 1994:338). These laws worked in the 37 states that enacted them, scuttling an active market for corporate control. This insulation from the takeover market was effectively undone by *Edgar v. MITE Corp. (1982)*. *Edgar* declared an Illinois anti-takeover law to be an unconstitutional violation of the Williams Act. By extension, the ruling effectively struck down similar laws all over the country. By clarifying the legal standard *Edgar v. MITE Corp.* spawned a new wave of second generation anti-takeover laws which were now crafted to meet *Edgar*'s criteria. This second wave was followed by a larger wave of third generation anti-takeover laws

following another Supreme Court case, *Dynamics Corporation v CTS Corporation (1987)*, which further clarified the constitutional standard for antitakeover provisions.

Second and third generation anti-takeover laws came in several varieties, but three were most common.[42] Business combination laws require a time lag, typically lasting several years, from the time in which a shareholder acquires a specified amount of stock and when certain transactions – mergers, sale of assets – involving that shareholder can take place. By introducing such an onerous time lag, business combination laws not only impede quick turnarounds, but allow management to take all sorts of steps that are hostile to the intentions of potential raiders after a tender offer has been made but before any restructuring can occur, including taking on excessive debt or installing "golden parachutes" for upper level management. Business combination laws are seen by some analysts as being the most consequential of all of the second and third generation anti-takeover provisions (Bertrand and Mullnaithan 2003). Control share acquisition laws require the approval of a majority of shareholders to reinstate the voting rights of bidders who makes a "control share acquisition," which is typically defined as 20% or more of the voting shares of the target company. Thus, potential raiders must not only purchase a controlling share in the company, they must also gain the approval of the remaining shareholders in order to make a successful tender offer. What unites these two classes of laws is that, beyond being anti-takeover, they are also profoundly anti-shareholder.

The third common form of anti-takeover law is more complex in the distributional consequences to shareholders. Fair price laws were aimed at two tiered acquisitions, in

[42] I exclude poison pill laws from my analysis because, unlike other anti-takeover laws, poison pill laws simply allowed firms to adopt the pills, rather than mandate that they be written into the corporate charter. Moreover, many firms had begun to adopt poison pills before state laws explicitly allowed them to, leaving the question of legal salience unclear.

which bidders make generous buyout offers to just enough shareholders to gain control, and then offer a lower price to remaining shareholders in a second tender offer. The effect is to create a prisoners dilemma among shareholders. A shareholder may find a tender offer to be inadequate, but the fear that 51% his or her peers will accept it can drive the shareholder to accept a bid against their better judgment for fear of being left with a second stage price that is even lower (Prentice 1988). Fair price laws mandate that bidders offer a single price to all shareholders, allowing them to make a more considered decision.

A fair amount of literature exists on the effects of these anti-takeover laws. Firms incorporated in states with anti-takeover laws have mangers who funnel more firm revenue into their salaries (Bertrand and Mullainathan 1999), engage in less new plant creation and are generally less profitable then firms incorporated in states that do not have anti-takeover laws (Bertrand and Mullainathan 2003). Share prices of securities listed by affected firms tend to decrease following the enactment of an anti-takeover law as a result (ex. Ryangaert and Netter 1988). Roe (1994) notes that the enactment of Pennsylvania's third generation anti-takeover law in 1990, which was particularly severe and noteworthy for the relatively large number of firms incorporated in Pennsylvania at the time, cost shareholders an estimated $3 billion in depressed share prices.

5.3.2 The Politics of Anti-Takeover Laws

The politics of anti-takeover laws at the state level are different than the politics of insider

trading laws or shareholder voting rights at the national level noted in chapter 4. First, capital flight doesn't really have the same meaning across US state lines as across national lines, as Delaware is effectively the only state that relies on incorporation fees as a significant source of revenue. Moreover, there is no variation across states in electoral laws, as there is across national lines. For shareholder and manager interest groups however, takeover laws are critically important in much the same way as the corporate governance policies examines in chapter 4.

For managers, anti-takeover laws are a god-send. Managers could often adopt antitakeover tactics into their corporate charter, but doing so typically required a majority vote by the shareholders, who were increasingly loathe to assent. Anti-takeover laws mandated the adoption of these tactics into the corporate charter, allowing managers to avoid getting shareholder approval on the matter. A further benefit of anti-takeover laws was that the shareholder meeting process is a far more time consuming one than the legislative process. In the face of a potential hostile takeover, it was simply more efficient for target companies to appeal to the legislature than their own shareholders.

In practice, managers were prodigious users of their lobbying capabilities in order to resist takeover attempts. To quote Roe (1994)

> Asher Edelman bid for Burlington Industries, a North Carolina company, in 1987. On April 23, 1987, two days after the Supreme Court announced *CTS*, the North Carolina legislature required bidders to get a favorable vote from 95 percent of stockholders; Burlington's managers controlled more than 5 percent of the stock, making a takeover somewhat difficult without managerial approval. When Dayton Hudson, a Minnesota company, becomes a target two months later, its managers "got Minnesota to hold a special legislative session. Within hours the state had a new anti-takeover

> bill." ... In July 1987 Greyhound, an Arizona company, feared a takeover and got a special session of the Arizona legislature to pass an anti-takeover bill. "Greyhound said jump and I said 'How High'" said state representative Jim Skelly. (339).

Pennsylvania's 1990 anti-takeover bill was issued at the behest of Armstrong Industries, a flooring company facing a takeover attempt. Massachusetts' 1987 control share-acquisition law in was prompted by concerns from Gillette Co. and was even signed by Michael Dukakis on the Gillette softball field. It wasn't just appeals by individual companies facing takeover attempts. Corporate lobby groups such as the Business Roundtable and various other chambers of commerce poured money and energy into these campaigns.

Anti-takeover laws were a mixed bag from the shareholders' standpoint. Shareholders benefited when takeovers were "done right", which is to say that inefficient firms were taken over and retooled into more efficient and more profitable enterprises with higher share prices.[43] On the other hand, pensions were burned by the greenmailing and two-tiered takeovers that were common to the era. Shareholders therefore had an incentive to lobby for laws that preserved the takeover market, but that nonetheless limited some of its anti-shareholder excesses.

It is important to note, also, that the stakes for pension funds were higher than simply the impact on their portfolios by the depressed share prices of affected firms. In most states, the number of incorporated firms is so trivially small that any effect would be

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[43] Recall that by this time most large pension funds were primarily invested in indexed strategies, and their investments, swollen with the money flood that followed the NLRB's *Inland* decision and the passage of ERISA, were often so large that they were effectively illiquid anyway. Because they could not take the "Wall Street Walk", the takeover market, along with the shareholder proposal process was one of their only mechanisms to reign in management.

minute, and hardly worth the lobbying costs. The fear for many pension fund executives was that a wave of anti-takeover laws would put pressure on managers to reincorporate into states with more management friendly laws. This, in turn, could lead to a race to the bottom, in which other states, particularly Delaware, would have to follow suit with antitakeover laws of their own to protect their revenue stream, which is exactly what happened (Roe 1994,Romano 1992).

Public pension funds, as an organ of state government themselves, did not contribute money to political campaigns as part of their lobbying efforts. Many pension fund executives testified at hearings, and several spent considerable efforts lobbying individual legislators.[44] The most compelling point a state pension fund could make is simply that the retirees would suffer in states with large pension systems heavily invested in corporate equity if anti-takeover laws were enacted and spread. In terms of the theoretical model, the key contribution of pension funds would be to shift government perceptions of the economic impact of anti-takeover laws – the W_G parameter – rather than by offsetting insider contributions with money of their own.

Of course, we know how the anti-takeover story ended: 38 states enacted at least one business combination law or control share acquisition law. The massive build up of pension fund assets were not enough to stop that. However, this does not mean that pension funds were completely inert in this process. 12 states did not enact any of these laws, and the timing of enactment across states varies widely. Public pension funds may very well have impacted politicians' perceptions of their own self-interest in shareholder

[44] Of course, even this lobbying ability was often curtailed by politics. In Pennsylvania and in Massachusetts, Governors went as far as ordering their pension funds not to testify against anti-takeover laws.

friendly policies, either implicitly, simply by existing and holding so much corporate equity, or explicitly through the lobbying process. In either case, I expect to find the same outcome: states whose pension systems were large enough and sufficiently invested in corporate stock should be less likely to adopt laws that damage shareholder interests. In this case, I expect that to take the form of fewer business combination laws and control share acquisition laws, and more fair price laws.

Qualitative evidence to establish the validity of pension fund influence is hard to come by, for several reasons. First, not much was written about anti-takeover laws at the time, with the exception of Pennsylvania's 1990s law, which was particularly controversial and therefore well covered in media outlets such as the Wall Street Journal and New York Times, and Massachusetts' 1987 law, which coincided with Governor Dukakis' run for the presidency. Even in this, there is a scant paper trail of the politics involved, beyond general descriptions of shareholders battling managers. What was written at the time by legal scholars and economists largely side-steps the issue of politics, and to the extent that it is mentioned focuses on management's ultimately victorious role. Compounding matters, many of the individuals involved in these legislative battles are now, 25 years later, hard to reach, and, I have found, typically quite hazy about the details. However, quantitative evidence can be brought to bear. Such findings are mute to precise causal mechanism at play, but they can be suggestive nonetheless. I turn now to these quantitative tests.

5.4 Tests

5.4.1 Sample

To test my hypotheses I construct a state-year dataset for all 50 US states from 1982 to 1994.

5.4.2 Dependent Variable

I focus my analysis on the three kinds of anti-takeover laws that were most often enacted during the 1980s and early 1990s: Fair price laws, control share acquisition laws and business combination laws. I use separate analyses for these variables because while all are anti-takeover, not all are anti-shareholder, and I expect to find that the extent of pension fund stock holdings will have different impacts on different sorts of laws.

5.4.3 Method

I employ a single failure event history analysis using the adoption of a second or third generation anti-takeover law as the failure event. I use a Cox model as my baseline model, but supplement these results with estimations using fully parametric models specified with a log-logistic distribution, which I found to best fit the data. As with the log-normal model used in chapter 4, the log logistic model is reported in accelerated failure time, yielding coefficients with the opposite sign as the Cox model.

5.4.4 Independent Variable

My primary independent variable, *log Pension Stock Holdings,* is equal to the log of total corporate equity holdings by all state administered pension funds in 1981, the year before *Edgar* was decided. All public pensions are consolidated into a single fund in some states, in which case the value of *log Pension Stock Holdings* is simply the market value of the equity in that portfolio at the time of the survey in 1981. Other states administer several funds. California, for example, administers CalPERS, CalSTRS (for public school teachers) a University of California employee pension fund and a separate pension fund for Judges. To find the value of these states I simply added up all of the holdings to create a synthetic portfolio covering the entire state system. I exclude locally administered funds as they are not known for any sort of legislative activism, and, in any case, are typically quite small, even in the aggregate. The prominent exception is NYCERS, which is both large and activist, but is nonetheless excluded form the sample. I use pre-Edgar data rather than annual data because it is possible that the stock holdings of pension funds are themselves a function of the spread of antitakeover laws, which would lead to endogeneity problems. This data is taken from the 1981 edition of the US Census Bureau's Survey of Retirement Systems.

Control Variables

I include several control variables in my analysis. First, I control for the existence of a

first generation anti-takeover law, which is taken from Warren (1984). It is entirely possible that the pre-*Edgar* equity holdings reflect the pre-*Edgar* legal environment, and to the extent that the existence of first generation laws predicts the adoption of second and third generation laws, omitting this variable leaves open the possibility of omitted variable bias. I control for state GDP and unemployment rates using data taken from the State Policy and Politics Quarterly dataset. I control for whether or not there is a ban on corporate giving to campaigns using data from Feigenbaum and Palmer (multiple editions) as a way of gauging whether some states were simply more fertile ground for management lobbying.[45] This variables is coded 1 if there is no cap on corporate gift giving to state political campaigns and 0 otherwise. I control for the partisanship of the governor, upper house and lower house (which are coded identically in the case of unicameral Nebraska) with a variable coded 1 for Democrats and 0 for Republicans, taken from Klarner (2003). It is certainly possible that pension fund equity limits, which are typically set by some organ of elected state government, follows a partisan pattern, which could confound my results if a similar partisan split effects the adoption of anti-takeover laws. I also control for the existence of other anti-takeover laws and include regional dummies for the Northeast, South, Mid-West and West.

5.4.5 Results

The results of my models are listed in table 5.1. Models 1 and 2 use the enactment of a business combination law as the failure event. I expect to find that states with a pension

[45] Given the wide gap between management campaign giving and shareholder campaign giving, I expect this variable to primarily pick up management entry points and not shareholder.

system that has a large amount of stock in its portfolio should be less likely to support the enactment of a business combination law. As such, I expect to find a negative coefficient on *log Pension Stock Holdings* in model 1, which uses a Cox estimator, and a positive coefficient on *log Pension Stock Holdings* in model 2, which uses a log-logistic estimator that is reported in accelerated failure time. That is exactly what I find, though both coefficients are only statistically significant at the .1 level. Among my control variables I find consistent evidence across both models that states that already had a fair price provision put into their corporate law were more likely to enact a business combination law, though, interestingly, the existence of a first generation statute is insignificant. No other variable is consistently signed and statistically significant across the two models.

Models 3 and 4 use the adoption of a control share acquisition law as the failure event. As with models 1 and 2, I expect to find a positive coefficient on *log Pension Stock Holdings* in model 3 and a negative coefficient on *log Pension Stock Holdings* in model 4. While the directionality of the coefficient are in line with my expectations, neither of the coefficients are statistically significant. Among my control variables, only *first generation anti-takeover law* is consistently signed and statistically significant in both models, and it bears the expected sign in each case. States that had an anti-takeover law struck down by *Edgar* were more likely to enact a control share acquisition law.

Models 5 and 6 use the adoption of a fair price law as the failure event. Unlike business combination laws and control share acquisition laws, I expect higher values of l*og Pension Stock Holdings* to correlate with a higher probability of enacting a fair price law. This is exactly what I find in both models. *Log Pension Stock Holdings* is

Table 5.1 Event History Analyses of Second an Third Generation Anti-Takeover Laws												
Model #	1		2		3		4		5		6	
DV	Business Combination Law				Control Share Acquisition Law				Fair Price Law			
Method	Cox		Log-Logistic		Cox		Log-Logistic		Cox		Log-Logistic	
	Coeff	SE	Coeff	SE	Coeff	SE	Coeff	SE	Coeff	SE	Coeff	SE
log pension stock holdings	-0.07	0.04 *	0.05	0.03 *	-0.03	0.04	0.01	0.04	0.10	0.05 **	-0.56	0.29 **
first generation law	0.11	0.66	-0.29	0.26	1.53	0.66 **	-1.35	0.60 **	0.96	0.80	-3.43	1.54 **
business combination law					0.41	0.53	-0.03	0.48	3.18	0.45 ***	-20.77	6.35 ***
control share acquisition law	0.50	0.43	-0.51	0.21 **					0.36	0.52	-0.27	0.51
fair price law	2.46	0.47 ***	-1.38	0.29 ***	0.84	0.63	-0.56	0.42				
cap on corporate giving	-0.15	0.42	0.53	0.30 *	-0.32	0.45	0.21	0.36	0.96	0.42 **	-0.36	0.22
Democratic Governor	0.68	0.41 *	-0.06	0.21	-0.13	0.46	0.19	0.33	-0.36	0.47	-0.33	0.34
Democratic Senate	0.37	0.48	-0.06	0.27	-0.33	0.63	0.17	0.50	-0.26	0.59	-0.78	1.40
Democratic House	-1.09	0.68	0.50	0.30 *	0.38	0.58	-0.63	0.57	0.60	0.54	-6.44	1.32 ***
log State GDP	0.33	0.24	-0.23	0.12 *	0.12	0.25	-0.07	0.22	0.22	0.36	0.01	0.24
unemployment	-0.12	0.15	0.10	0.05 **	-0.23	0.16	0.16	0.10	0.13	0.13	-0.1	0.05 *
south	-1.16	0.84	-0.07	0.24	-1.56	0.79 **	0.96	0.60	1.08	0.84	-0.45	0.87
west	-0.17	0.94	-0.11	0.40	1.38	0.85	-1.36	0.73 *	0.08	1.05	8.41	3.49 **
midwest	0.39	0.71	-0.18	0.19	0.69	0.71	-0.81	0.48 *	0.10	0.79	0.07	0.98
_cons			4.07	1.32 ***			3.82	2.49			20.99	5.66 ***
N	422		422		421		421		405		405	
Log Likelihood	-83.98		-13.67		-86.99		-38.87		-70.18		-24.17	
Failure Events	30		30		27		27		27		27	

statistically significant at the .05 level and positive in model 5 and significant at the .05 level and negative in model 6. My control variables again perform poorly. Only the presence of a business combination law is statistically significant in both models, and it bears the expected sign.

These results suggest that state pension funds were consequential in the antitakeover law debates, at least with respect to business combination laws and fair price laws. Controlling for a variety of potentially confounding variables, states with large equity position in their pension systems were more likely to adopt shareholder-friendly laws than states with small or non-existent equity positions. In fact, the equity position of pension funds outperforms every other variable in the model. Perhaps most supportive of my theory is the fact that it is not just that states with heavily invested pension funds had fewer antitakeover laws, but that they had fewer of the sort of anti-takeover laws that hurt shareholders and more of the antitakeover laws that help shareholders. While mute to the micro-processes at play, these results nonetheless suggest support for political models of corporate governance law that feature pension funds as a central actor.

Robustness Checks

One possible critique of the above analysis is that *log Pension Stock Holdings* may be picking up the overall size of the pension system rather than its particular position in equity. My causal mechanism relies on the exposure of pension funds to the stock markets and the ability of these funds to recoup the costs of activism through gains in

share price, or, alternatively the exposure of politically salient pension fund assets to corporate governance legislation. To get a more precise sense of what is actually driving the results noted in Table 5.1, I reestimate all of my models controlling for a new variable, *log Pension Assets*, which is the log of the total value of the assets under management across all asset classes, including stocks. The results for these tests are noted below in Table 5.2.

The results reported in Table 5.2 are virtually identical to those reported in Table 5.1. In each model *log Pension Assets* is statistically insignificant, while *log Pension Stock Holdings* retains its statistical significance and substantive interpretation. States whose pension funds were heavily invested in the stock market were less likely to enact a business combination law and more likely to enact a fair price law, even controlling for the overall size of the pension system. The only change worth noting is that *log Pension Stock Holdings* is now statistically significant at the more conventional .05 level in models of business combination laws, while *log Pension Stock Holdings* loses some statistical significance in the cox model of fair price laws, moving from statistically significant at the .05 level to the .1 level.

A second critique is that these results may be driven by California, whose corporate governance activism is uniquely robust among state pension systems. Not surprisingly, California is one of the few states with no second or third generation anti-takeover laws of any kind (including, contrary to my expectations, a fair price law). Table 5.3 replicates Table 5.2, excluding California from the sample.[46]

[46] In practice, it makes no difference if I replicate Table 1 or Table 2 excluding California.

Table 5.2 Event History Analyses of Second an Third Generation Anti-Takeover Laws Robustness Checks												
Model #	7		8		9		10		11		12	
DV	Business Combination Law				Control Share Acquisition Law				Fair Price Law			
Method	Cox		Log-Logistic		Cox		Log-Logistic		Cox		Log-Logistic	
	Coeff	SE	Coeff	SE	Coeff	SE	Coeff	SE	Coeff	SE	Coeff	SE
log pension stock holdings	-0.08	0.04**	0.05	0.02**	-0.03	0.04	0.01	0.03	0.10	0.06*	-0.48	0.23**
log pension assets	0.46	0.53	-0.32	0.43	-0.19	0.70	-0.19	0.46	0.55	0.75	-0.31	0.58
first generation law	0.14	0.65	-0.21	0.25	1.55	0.68**	-1.27	0.60**	0.86	0.71	-2.96	1.35**
business combination law					0.42	0.54	-0.02	0.41	3.05	0.45***	-19.16	6.62***
control share acquisition law	0.48	0.44	-0.49	0.16**					0.45	0.50	-0.28	0.50
fair price law	2.44	0.49***	-1.10	0.54*	0.85	0.63	-0.52	0.37				
cap on corporate giving	-0.07	0.41	0.35	0.31	-0.37	0.48	0.15	0.48	1.08	0.42**	-0.43	0.23*
Democratic Governor	0.71	0.42*	-0.07	0.17	-0.14	0.47	0.18	0.33	-0.33	0.46	-0.32	0.33
Democratic Senate	0.42	0.46	-0.05	0.29	-0.33	0.63	0.16	0.49	-0.18	0.60	-0.81	1.43
Democratic House	-1.28	0.70	0.44	0.24*	0.43	0.61	-0.54	0.56	0.39	0.52	-6.19	1.36***
log State GDP	-0.14	0.57	0.16	0.52	0.34	0.84	0.15	0.62	-0.43	1.02	0.31	0.65
unemployment	-0.15	0.16	0.10	0.05**	-0.22	0.16	0.16	0.14	0.13	0.13	-0.08	0.05
south	0.36	0.90	-0.11	0.52	-1.53	0.82*	0.92	0.59	1.12	0.85	-0.46	0.88
west	-0.78	0.66	-0.24	0.69	1.48	0.95	-1.17	1.05	-0.21	0.93	7.74	4.11*
midwest	0.67	0.57	-0.26	0.53	0.72	0.71	-0.73	0.66	0.07	0.77	0.13	1.02
_cons			4.36	1.15***			3.94	2.18			20.40	5.26***
N	422		422		421		421		405		405	
Log Likelihood	-83.76		-13.18		-86.97		-38.81		-69.96		-24.10	
Failure Events	30		30		27		27		27		27	

Table 5.3 Event History Analyses of Second an Third Generation Anti-Takeover Laws Robustness Checks – No California												
Model #	13		14		15		16		17		18	
DV	Business Combination Law				Control Share Acquisition Law				Fair Price Law			
Method	Cox		Log-Logistic		Cox		Log-Logistic		Cox		Log-Logistic	
	Coeff	SE	Coeff	SE	Coeff	SE	Coeff	SE	Coeff	SE	Coeff	SE
log pension stock holdings	-0.08	0.04 **	0.05	0.02 **	-0.03	0.04	0.01	0.03	0.09	0.06 *	-0.48	0.23 **
log pension assets	0.46	0.53	-0.32	0.43	-0.18	0.68	-0.07	0.46	0.52	0.74	-0.31	0.58
first generation law	0.11	0.63	-0.20	0.25	1.48	0.65 **	-1.32	0.58 **	0.85	0.76	-2.96	1.35 **
business combination law					0.40	0.54	-0.01	0.40	2.94	0.44 ***	-20.30	6.83 ***
control share acquisition law	0.46	0.44	-0.49	0.16 ***					0.37	0.48	-0.28	0.50
fair price law	2.41	0.48 ***	-1.09	0.54 **	0.72	0.67	-0.39	0.35				
cap on corporate giving	-0.07	0.41	0.35	0.31	-0.39	0.47	0.18	0.45	1.05	0.41 **	-0.43	0.23 *
Democratic Governor	0.68	0.42	-0.07	0.18	-0.18	0.46	0.29	0.32	-0.43	0.46	-0.32	0.33
Democratic Senate	0.43	0.45	-0.05	0.29	-0.28	0.63	-0.03	0.50	-0.07	0.58	-0.81	1.43
Democratic House	-1.28	0.68 *	0.44	0.24 *	0.37	0.60	-0.51	0.55	0.35	0.51	-6.94	1.50 ***
log State GDP	-0.10	0.58	0.16	0.52	0.45	0.84	-0.19	0.66	-0.23	1.06	0.31	0.65
unemployment	-0.15	0.16	0.10	0.05 **	-0.23	0.17	0.16	0.14	0.12	0.13	-0.08	0.05
south	0.28	0.91	-0.11	0.53	-3.21	1.00 ***	2.55	1.19 **	-0.23	1.19	-8.13	4.21 *
west	-0.85	0.67	-0.24	0.70	-1.62	1.00	1.61	1.12	0.98	0.85	-8.58	4.24 *
midwest	0.59	0.58	-0.26	0.53	-0.89	0.62	0.74	0.63	-0.02	0.87	-8.00	4.15 *
_cons			4.37	1.17 ***			4.47	2.03 **			29.27	8.18 ***
N	410		410		409		409		393		393	
Log Likelihood	-83.56		-13.17		-86.49		-37.49					
Failure Events	30		30		27		27		27		27	

The results in Table 5.3 are, almost identical to this reported in Tables 5.1 and 5.2. Even excluding California, states with more equity assets in their pension funds were slower to enact business combination laws and quicker to enact fair price laws.

5.5 Summary

Why do some American pension funds have an impact on corporate governance issues while others do not? My hypotheses suggest that pension funds need to be properly motivated to care about corporate governance in the first place, and that they be able to overcome free riding problems. On the latter issue, the fiduciary duty of pension fund managers in the United States, established through ERISA, the prudent man standards and the Avon letter appears to be a sufficient motivation to care about corporate governance, though political constraints placed on some public pension plans can mitigate this.

On the latter issue, while some elements of corporate governance activism by state retirement systems is coordinated through the CII, state based pension funds are, for the most part, left to their own to fund their corporate governance activism. Corporate governance activism at the firm level is not cheap, and this was particularly true during most of the takeover era, before the SEC reformed rules governing communication between institutional investors in 1992. The fiduciary duty of pension fund executives suggests these expenses should only be incurred if a fund is large enough to reap the benefits. The main focus of this chapter, therefore, is on size of the equity holdings of

individual pension funds. Unsurprisingly, only funds with holdings large enough to to recoup their investment in corporate governance activism have taken an active stance towards the corporate governance of the firms they invest in.

Pension fund impact on the policy level is far less documented, but the results of my statistical tests suggest that here too, state pension funds with the largest equity stakes – not the largest funds, necessarily, but those with the largest equity stakes – are most able to impact the policy environment in their home state. The fact that public pension funds do not contribute money to state policy makers suggests that the pensions are effective by acting, implicitly or explicitly, to shift government perceptions of its stake in corporate governance's economic consequences.

In the next chapter I will examine Polish pension funds created by that country's 1999 pension reform. Relative to the size of the market, the larger Polish pension funds are considerably bigger than any of the American pension funds. Moreover, they are not directly accountable to government, and are effectively sheltered from the interests of their sponsoring firm, alleviating conflicts of interests. If size and independence were a sufficient condition for corporate governance activism, we would expect to see a significant amount of activity. As I will show, however, this is not the case.

Chapter 6 – An Application to Polish Pension Funds: Does Pension Reform lead to Corporate Governance Reform?

While American pension funds, particularly CalPERS and TIAA CREF, are the reference point for pension fund activism, a new breed of pensions is rising around the world, one that holds the possibility, and occasionally the explicit promise, of redefining corporate governance in the countries in which they operate. This category of pension funds are the often massive funds that are created as a result of national pension reform. This chapter will explore the reality of corporate governance activism in Poland, which reformed its pension systems in 1999. Before addressing the specifics of the Polish case, however, it is first useful to note the development of national pension systems that precipitated reform in the first place.

6.1 The Spread And Rationale Of Pension Reform

The first national public pension system was introduced in Bismarckian Germany in 1889, as part of a wider ranging set of reforms that would lay the foundation of the German welfare state including the introduction of a health insurance system (1883) and a disability insurance system (1884). Bismarck's old age pension system originally served as a salary replacement for Germans age 70 or older, which, given that the average life expectancy in Bismark's Germany was 45, was a relatively narrow program. The motivation for Bismarck's old-age pension was to diffuse the social unrest that accompanies mass poverty, and thereby diffuse the potential rise of a broader labor

movement (Bonoli 2000). As Bismarck noted, "Anybody who has before him the prospect of a pension, be it ever so small, in old age and infirmity is much happier and more contented in his lot, much more tractable and easy to manage,"

Following Prussia, Denmark instituted its own public pension system in 1891, followed in turn by New Zealand (1898) and the United Kingdom (1911). All three of these systems are often noted as “Beveridgean” systems after the principle author of Great Britain's system. The focus of these plans was on poverty reduction, rather than income replacement. All of these systems were originally financed through general taxes, rather than the Bismarckian alternative, which was financed through a specific levy on wages. As income taxes became sharply more progressive during and after WWI (Scheve and Stasavage 2009), the Beveridgean systems became notable for its high levels of intra-generational income redistribution as the wealthy financed a greater share of working class retirements (Orenstein 2008). Over time, states typically reformed their systems to reflect a balance of Bismarckian elements – benefits tied to working income – as well as Beveridgean elements – the provision of a minimum pension aimed at alleviating poverty among poorer pensioners (Krieger and Traub 2008). By the end of the 1950s virtually every European country and most of the Western Hemisphere had adopted some sort of a national public pension system. Africa, the Middle East and Asia followed suit in a wave of policy adoptions in the 1950s and 1960s (Orenstein 2008: 20).

6.1.1 Strains on the System

Despite the manifest popularity of national pension systems, calls for major reforms began almost as soon as these systems took hold, with policy makers pushing to replace defined benefit plans with defined contribution plans.[47][48] The most commonly cited and well understood factor in the movement is demographic pressure. One of the side effects of the second half of the 20th century's prosperity gains around the world has been rising life expectancy. To take a few prominent example from 1960 – 2000, life expectancy increased from 70 to 77 in the United States, from 68 to 80 Italy, from 57 to 77 in Chile and from 36 to 70 in China (WDI, accessed March 29, 2009).

As life expectancy rises, so too does costs of providing a pension for a country's retired population. Add to this the impact of the global post-war baby boom and dropping fertility in much of the world, and governments were left with a severe imbalance between pension liabilities and the revenue being generated through payroll taxes or through general tax revenues to fund these liabilities. The potential impacts are grim. As the World Bank, one of the most consequential backers of pension privatization, noted in 1994, "[unreformed public pension systems] may actually hinder growth – through high wage taxes, which cause evasion and push labor into the less inefficient informal sector; through rising fiscal deficits, which fuel inflation; by squeezing out growth promoting public spending, such as education or health services for the young; or

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47 Defined contribution systems are those in which pensioners pay in a fixed amount, and their returns are subject to the performance of the investment portfolio those funds are placed in. The alternative is a defined benefit plan, in which benefits paid out are determined by the government and, while typically tied to the amount of money paid into the system, are not subject to market fluctuations.

48 Of course, just because countries have good reasons to privatize their pension systems doesn't mean that they will. As Brooks (2007) notes, a variety of pressures including a countries exposure to the world economy, domestic political structures and the extent to which their regional peers have reformed their pension systems all condition the salience of the above noted pressures and the extent which domestic politicians are pressured to reform their own pension systems.

through a combination of all three." (World Bank 1994: iv).

6.1.2 Wave of Reform

In the face of these demographic pressures, many countries have opted to substitute, or partially substitute, their public national pension system with a private alternative. The first country to enact such a reform was Chile in 1981. In some ways, Chile's reform was typical of reforms to follow, and of ongoing debates concerning the long term solvency of pay-go (as in "pay as you go", in the sense that the benefits of current retirees are financed with the contributions of current workers, rather than the accumulated contributions of the retiree) national pension systems around the world. Chile enacted is national pension scheme, the first of its kind in Latin America, in 1925. As Edwards (1998) notes, Chile's original pension system was not intended to be a pay-go system and at one time accumulated substantial reserves to finance benefits. Political mismanagement of pension benefits led to the system's transformation into a pay-go system. Blue-collar workers faced a minimum retirement age of 65, while others could retire as early as 42 and nonetheless receive their full pension. Government bureaucrats were eligible for a pension equal to 100% of current salaries in their former position (which thus protected against inflationary erosion) while blue-collar workers received a considerably smaller share of the received wages during their working career. Chile's pension system was nearing bankruptcy and facing a demographic crunch by 1979 in which only 2.5 workers were supporting the benefits of every retiree, down from a ratio

of 12 workers per retiree in 1955 (Edwards 1998). While budget shortfalls could have been made up by increasing taxes or decreasing benefits or both, as was done in the United States in 1977 and again in 1983, Chile instead opted to privatize their social security system using a design formulated by then Secretary of Labor and Social Security, Jose Piñera.

Jose Piñera is a Harvard educated economist who began teaching at the Catholic University of Chile in 1975. In 1978 he was tapped by General Pinochet to serve in his cabinet as Secretary of Labor and Social Security, in part because of his outspoken commitment to the Chicago school of economics, which fit well with Pinochet's larger commitment to promoting free markets and reducing the size of the public sector. Piñera wasted little time in addressing the stress facing the Chilean national pension system by proposing his social security reform program on November 4, 1980 and enacting it in May of 1981. The proposal required a dramatic reconceptualization of the national pension system, which could be opted into by existing workers but was mandatory for new workers. The central element of Piñera's system was to re-channel payroll taxes (then 10% of wages) out of Chile's general taxation revenue stream and into Personal Retirement Accounts (PRAs). Workers then had the responsibility to choose from a list of approved pension fund managers called AFPs (Administradora de Fondos de Pensiones, or Pension Fund Managers), whose track record is made publicly available by the system regulator (la Superintendencia de Pensiones). AFPs, many of whom are subsidiaries of large, multinational financial institutions, primarily insurance agencies, invest a worker's PRA in a portfolio whose composition is largely determined by

government-established limits on certain asset classes. At the end of a workers' career they must use their amassed investments to buy an annuity from the AFP, which takes the place of a government issued pension benefit. The Chilean government guarantees a minimum pension by “topping up” the accounts of workers whose funds are insufficient to purchase a minimally large annuity but have worked for a minimum of 20 years.[49] Worker-contributors can freely switch funds managers at any point (a fee charged by the AFP is legally permissible, though none actually charge it).

Following Chile's adoption, Great Britain enacted a pension reform of its own in 1986, though the British reforms were more modest, only providing for the creation of a parallel system that British workers could opt into, rather than the Chilean reform which phased out public pensions altogether. The real cascade of reforms came in the 1990s, in part due to a demographic crunch that was getting worse, and in part though the energetic and increasingly global efforts of Mr. Piñera and the "The International Center for Pension Reform" which Piñera created in 1994 to organize his efforts. In 1993 Peru adopted reforms along the (cheaper) British model, followed in 1994 by Argentina and Colombia. Also in 1994 Sweden, headed by a socialist government introduced a more ambitious set of reforms closer to the Chilean model, though relying on notional accounts that preserves pay-go financing but mimics the structure of a funded pension. Over the next several years reforms took hold across Latin America and, particularly, eastern Europe, where, as in Chile, political bargains had been struck under the socialist system that allowed for enormously generous and fiscally disastrous pensions for politically

[49] There are also various welfare programs in place that respond to extreme poverty without reference to a workers' working history

sensitive sectors of society. More recent reforms have occurred in South Africa, Nigeria, Kazakhstan, Uzbekistan and Taiwan.

6.1.3 Benefits of reform

Demographic strains are an important rationale for privatizing pension system and continues to be the primary factor cited by proponents of pension reform in the Unites States and elsewhere. But these are not the only implications of a privatized pension system that have been noted by reformers.

A second reason why countries have moved towards privatized pension funds is to help establish and modernize national capital markets. There are several channels through which a funded national pension system could improve the function of capital markets, particularly in emerging economies. To understand how, it is first necessary to recognize that pension fund administrators typically face a regulatory environment that demands that they hold a significant amount of domestically issued public debt in their portfolios. Creating such a large market for public debt has a variety of political-economic implications. First, and most directly, increasing the demand for government issued debt to helps lower interest rates, and creates a market for longer-maturity debt than would otherwise be possible. This helps government borrow more cheaply and adds a degree of stability to their debt load by reducing the need for potentially expensive debt rollovers that frequently occur when debt is financed through short maturity bonds. This is particularly important for long-term expenditures in infrastructure development and

other areas that can help contribute to macro-economic growth.

Second, because governments can issue longer term bonds, a market can establish a "bench mark" rate for a wider variety of maturities. A bench mark rate is the lowest interest rate that investors will demand for domestically issued bonds of a certain maturity. The benchmark rate for issuers on a particular market is almost always set by the government, as sovereign debt is usually considered the safest. In the absence of a benchmark at a variety of maturities it is more difficult for investor to determine the appropriate interest rate for corporate debt, and therefore inhibits the formation of a market for long-maturity corporate debt, which is a key to the financial success of domestic firms.

Beyond publicly issued bonds, a considerable portion of privatized national pension portfolios are typically allocated towards domestic corporate equities, though the exact amount varies widely across countries and within countries over time. The introduction of demand into the domestic stock market reduces the cost of equity financing. This provides considerable incentives for corporations to go public on the domestic stock market, which avails them of a more efficient financing system, and in the process creates listing fee revenues for local exchanges, which can then be used to modernize trading systems, bolster the enforcement of exchange-specific rules and otherwise create a framework that is more attractive to foreign and domestic investors.

Another rationale for reform is that the World Bank and the IMF are champions of pension reform and have conditioned loans for Argentina (1994), Bolivia (1997) and Bulgaria (2002) on these countries reforming their pension systems. In many cases,

particularly in Eastern Europe, international financial organizations such as the World Bank and the IMF, along with non-financial international organizations such as the OECD and USAID have been crucial contributors to reform efforts (Orenstein 2008).[50]

6.1.4 The Corporate Governance Channel

For the purposes of this dissertation, the most important side effect of privatizing national pension systems is the possibility that pension reform could instigate corporate governance improvements by introducing large institutional investors capable of monitoring firm performance, lobbying for pro-shareholder rules, and by turning the population into minority shareholders, and in the process shifting government perceptions of corporate governances' importance (i.e. shifting the WG parameter of the model). To be clear, the impact on corporate governance has not been a primary concern for pension reformers, particularly as compared to relieving the fiscal burden or developing government and corporate debt markets. But neither was the corporate governance angle overlooked. Writing for the World Bank, Vittas and Michelitsch (1995) argue that newly created pension funds' "voice" in corporate affairs could help create more robust structures of corporate governance, lower monitoring costs, and avoid problems caused by "free riding". The anticipation of a corporate governance effect is reiterated in Catalan (2004) and Allen and Gourevitch (2008).

Whereas corporate governance might not be the most trenchant concern for

[50] Interestingly, despite Orenstein's work on the role of IFI's in promoting pension reform in Eastern Europe, including Poland, Jerzy Hausner, one of the architects of the Polish reform, insists that they played no role. Interview by author with Jrezy Hausner on 5/18/2009

observers of pension reform, pension reform is an incredibly big deal to observers of corporate governance. The introduction of an institutional investor as large as a nationalized pension system revolutionizes the political landscape for politicians and regulators as well as for the directors of corporate boards in whose companies these pension funds invest (or, just as importantly, don't invest).

6.2 Pension Reform In Poland

There are several reasons why the Polish case makes an interesting and useful contrast to the US case. First, the Polish pension system is an important case in that it is representative of a wider class of pension systems modeled after Chile. As noted above, many countries, particularly in Eastern Europe and Latin American have adopted such systems over the past 20 years, and understanding how they work is a key issue for the larger enterprise of understanding pension fund influence of corporate governance around the world. Second, the Polish government, led by the Treasury Ministry, has made stock market development a major goal, with the aim of cementing their status as the regional leader. Shoring up Polish corporate governance has been an acknowledged goal in that effort, and consequently there has been a raft of corporate governance reform efforts since the time of the pension system's establishment. For these reasons, Poland makes a uniquely rich case from which to draw insights into the role of pension funds in corporate governance policy making.

The bulk of my insights into the role of Polish pension funds came from a series

of interviews and questionnaires conducted between January and April of 2009. These interviews were conducted with the generous support of Ernst and Young Poland's Better Governance Programme. Many of these interviews were conducted in person during January of 2009 in Warsaw and Krakow, Poland. Follow up correspondences were carried out over email and telephone over the following three months. I interviewed a variety of people during this time, including senior executives at some of the largest pension fund administrators operating in Poland. Other interview subjects included Polish economists, lawyers, pension-fund-appointed independent board members, politicians, regulators and corporate governance professionals. All interviews were conducted in English, which is my native language.

I also reviewed as many of the relevant statutes, bylaws and position papers as possible, given my limited abilities with the Polish language. Many of these laws are available in English translation from IGTE (Izba Gospodarcza Towarzystw Emerytalnych, or Polish Chamber of Pension Funds), the KNF (Komisja Nadzoru Finansowego, or the Commission of National Finance) and the Warsaw Stock Exchange. When English translations were unavailable I relied on commonly used translation software. To buttress the qualitative evidence gathered during these interviews, I also gathered and analyzed quantitative data made available by the KNF, The Warsaw Stock Exchange, the Polish Forum for Corporate Governance, and the Polish Directors Institute.

Poland began a national conversation about pension privatization in 1991, almost immediately after the fall of communism, though this conversation was brief and the

topic of pension privatization was initially squashed by World Bank experts (Orenstein 2008). Poland had rising pension liabilities due to a low retirement age (57), and too high benefits, particularly for politically privileged interests such as agricultural workers (Chłoń et al. 1999, Orenstein 2008). While the demographics were not as unfavorable in Poland as elsewhere, they were nonetheless daunting. Spending on pensions in Poland by 1994 amounted to 15.3% of GDP, much closer to the continental high (Italy: 16.2%) than the continental low (Ireland: < 5%) (Chłoń et al. 1999). As baby-boomers began to retire, Polish economists foresaw a yawning gap in the dependency ratio and a pension system that would be effectively insolvent by the end of the decade.

The Polish government sought short term solutions via *ad hoc* tweaking of indexation and benefits, but this was ruled unconstitutional in 1994, forcing the Polish government to consider a more sweeping remedy. The reform camp was split into to those who wanted to maintain a defined benefit pay-go system, with adjustments made to the retirement age and to the formula for calculating benefits in order to reduce outlays and render the system solvent, and those who wanted to scrap the system in favor of a funded alternative. Leszek Miller, then minister of labor under the SLD-PSL coalition supported the more modest approach. Miller's conservatism was met by Grzegorz Kołodko's ministry of finance, which preferred reform along the Chilean model. This standoff would continue until Andrzej Baczkowski, a supporter of Chilean-style pension reform, replaced Miller as labor minister under SLD government in 1996. This new found consensus resulted in *Security Through Diversity*, a pension reform plan that was nurtured by Jerzy Hausner and Ewa Lewicka, Baczkowski's successors following his

death in 1997. The pension reform package was debated and passed into law by during 1997 and 1998. In August 1998 licensing began for potential fund administrators and the new pension system began operations on January 1, 1999.

6.2.1 Security Through Diversity

As the name suggests, the guiding principle of the Polish pension reform was to provide greater security to the retirement system by diversifying pension fund assets over multiple pillars, reducing pension fund assets' exposure to volatility in any particular sector. The first and third pillars are not particularly relevant for my purposes, with the former being a modified version of the pay-go system, and the latter being a relatively small system of occupation-sponsored pensions that are given preferential tax treatment according to the law.

The second pillar of the pension program created by *Security Through Diversity* is a mandated pillar through which 9% of a worker's earnings are collected by the Social Security Institution (ZUS, which also administers the first pillar pension scheme) and invested in personal accounts managed by one of the several funds that are licensed by the supervising body, which is currently organized under the Polish Financial Supervision Authority (Komisja Nadzoru Finansowego, or KNF). These funds operate as open mutual funds and are accordingly referred to as the Open Pension Funds (Otwatry Fundusz Emeraltalny, or OFE). As in the Chilean system, workers buy an annuity from their pension administrator at the time of their retirement to serve as their retirement

income. The size of the annuity that can be purchased depends on the both the amount of money that has been contributed by the worker over their career and the performance of the portfolio it was invested in.

The funds that comprise the OFE pension system are operated and administered by various sorts of financial institutions, including funds wholly owned by transnational insurance companies (ex. Aegon, AXA, Nordea), Polish financial institutions (ex. PZU, Skarbiec Emerytura), and various consortia of Polish and international financial institutions (ex. ING, Pozctylion). There were initially 21 licensed OFE administrators, though this number has been reduced to 15 through mergers and exits.

Collectively, the financial assets of the OFE system is large. Figure 6.1 shows the growth in OFE holdings as a percentage of Polish GDP from 2002-2007. OFE pension fund holdings have increased substantially, reaching 12% of GDP by 2007, and are projected to rise considerably in the future. Pertinently for the purposes of this chapter, much of these assets are held in domestic equities, making the OFE pension system a major player on the Polish stock market, collectively owning up to 10% of the stock market over the years from 2002-2007. While this makes the Polish pension fund industry smaller than their American counterparts in terms of market ownership, the prevalence of insider ownership in Poland makes this figure a bit misleading. It is estimated that the OFE pension system controls over 30% of free float on the Warsaw Stock Exchange, which is more comparable to the American pension industry (Grajewski 2009).

The size of the OFE funds vary greatly. Figure 6.2 shows the equity holdings of

Figure 6.1: Aggregate OFE Portfolio as a % of GDP

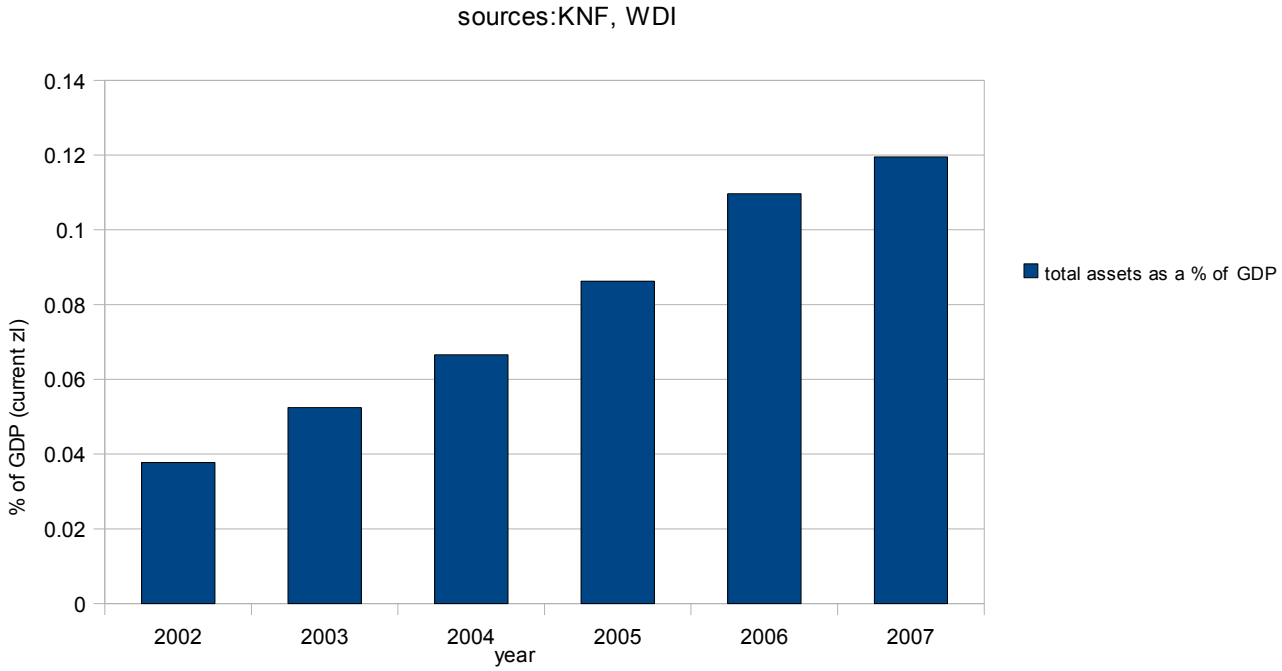
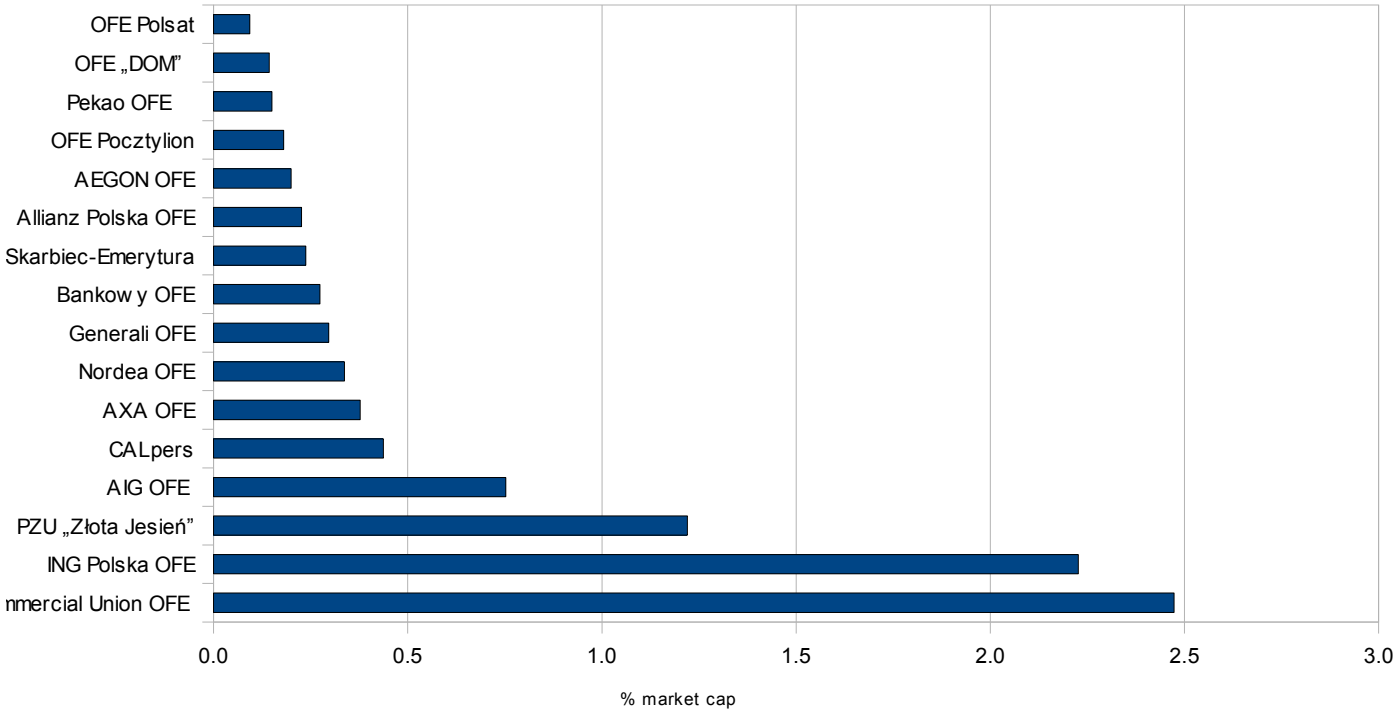


Figure 6.2: Percentage of Market Cap Accounted for By Individual Funds

source: KNF 2006 annual report, CALpers 2006 annual report, WDI



individual pension funds, expressed as a percentage of total stock market capitalization for the year 2006, with CalPERS' share of the US market included as a point of comparison. As can be seen, many of the individual pension funds, particularly the very largest - Commercial Union, ING and PZU - have equity holdings that are considerably larger relative to the Polish market than CalPERS' domestic (US) equity holdings is to the US stock market. This suggests that the larger Polish funds have more than sufficient equity stakes to justify and effect a considerable amount of corporate governance activism.

At the firm level, pension fund ownership can be even larger. Table 6.1 shows the extent of OFE pension fund holdings in 2007 for the 24 firms with the highest level of pension fund ownership. As can be seen, OFE pension collectively own considerable blocks in some of the largest firms in Poland. Cersanit, Polimex, Grupa Kęty, PBG, and Assecco are all current or recent member of the WIG20, and many of the other firms listed in table 6.1 are current or former members of the WIG 40. OFE pensions collectively own a greater than 10% stake in many other major Polish firms including PKN Orlen, Agora, KGHM and ING Bank Śląski. Individual OFE pensions also have considerable ownership stakes in some of these firms. Many of the largest pension funds – Commercial Union, ING, PZU and AIG - have stakes in excess of 10% in individual firms. PZU has ownership stakes approaching 20% in several firms.

6.2.2 Other Features of Polish Corporate Ownership

Beyond pension funds, dominant shareholders play a major role in Polish corporations.

Table 6.1

Firm	Total OFE ownership	% owned by largest OFE shareholder	largest individual share holder
ELEKTROBUDOWA S.A	56.65	11.07	ING
VISTULA&WÓLCZANKA S.A.	39.13	18.09	PZU
COMP SAFE SUPPORT S.A.	38.97	8.37	AIG
POLIMEX-MOSTOSTAL S.A.	36.54	9.10	Commercial Union
GRUPA KĘTY S.A.	36.38	11.74	ING
ECHO INVESTMENT S.A.	35.53	8.98	Commercial Union
ALMA MARKET S.A.	32.16	17.02	PZU
SANOCKIE ZAKŁADY PRZEMYSŁU GUMOWEGO STOMIL SANOK S.A.	32.06	8.65	Commercial Union
POLSKA GRUPA FARMACEUTYCZNA S.A.	31.66	7.84	ING
LPP S.A.	29.64	8.97	Commercial Union
WYDAWNICTWA SZKOLNE I PEDAGOGICZNE S.A.	28.24	14.87	AIG
CERSANIT S.A.	28.01	8.61	ING
ZELMER S.A.	27.25	11.60	Commercial Union
POLISH ENERGY PARTNERS S.A.	24.25	9.95	Generali
MOSTOSTAL-WARSZAWA S.A.	24.06	19.84	PZU
ATM S.A.	23.68	9.95	Polsat
SFINKS POLSKA S.A.	23.27	11.57	Commercial Union
PBG S.A.	22.67	7.09	ING
FARMACOL S.A.	22.61	7.47	ING
TETA S.A.	21.78	8.24	AIG
AMREST HOLDINGS N.V.	21.78	7.03	Commercial Union
ASSECO POLAND S.A	21.55	5.68	ING
INSTAL KRAKÓW S.A.	21.39	14.62	PZU
EMPERIA HOLDING S.A.	20.98	9.55	Commercial Union

source: KNF 2007

The dominant shareholder in Polish firms holds at least a majority of shares in 75% of companies listed on the WSE. 27% of WSE listed companies have dominant shareholders with greater than a 75% share. The median size of the largest voting bloc in WSE listed firms is 38-40 per cent (Aluchna 2009). This is roughly on par with European averages (Gourevitch and Shinn 2005; table 2.1 pg 18), but stands in sharp contrast to the US and UK. The marked ownership concentration that is present in Polish firms has increased substantially over the past 10 years (Aluchna et al.. 2007). Despite ongoing privatization efforts, and a private economy that encompasses 80% of GDP, the Polish Treasury maintains significant ownership of many firms, including many of the strategically important firms that comprise the largest share of the WIG 20.

6.3 OFE Pension Funds And Polish Corporate Governance

6.3.1 Corporate Governance Hard Law In Poland

Corporate governance in Poland mixes hard law with soft law. The foundation of Polish corporate governance in hard law can be traced back to the Act on the Privatization of State Enterprises (1990), which mandated a supervisory board for newly privatized Polish firms (Aluchna 2008). The first hard law addressing the securities market was drafted in 1991 and adopted regulations modeled heavily on Western European and American law, including the establishment of an independent and relatively empowered securities and exchange commission (Polish Securities and Exchange Commission, or PSEC) (Frankowski and Bodnar 2005). The Law on the Public Trading of Securities was enacted in 1997 to update the original 1991 act and regulates, among other things, the procedures

surrounding the acquisition of significant shareholdings. The Commercial Companies Code (CCC) was enacted in 2000 in order to replace the Commercial Code of 1934, which, understandably, had fallen out of step with the needs of a modern economy (Frankowski and Bodnar 2005). CCC reinforces the dual tier board structure for Polish companies, sets minimum rules regarding the participation of shareholders in a shareholder's meeting, regulates the adoption of anti-takeover devices and addresses a variety of other issues.

Most of the subsequent recent changes in Polish hard law, including CCC and The Law on the Public Trading of Securities, has been instigated by the need to harmonize national legislation with the recommendations of the European Commission, which Poland is obligated to do as a member of the EU since 2004. This happened most recently with the adoption of the "EC Directive on the exercise of certain rights of shareholders in listed companies", which was notified to the EC in January of 2009. The transposition of EU law into Polish law has been prompt and relatively uncontroversial.

These hard law measures are a large reason why Poland has been viewed as being among the more investor-friendly markets in central and eastern Europe since the beginning of capital market operations in the region in the early 1990s. The establishment of a centralized and empowered regulator along the American model helped ensure that Polish markets were considerably safer for investors than in regional peers, particularly the Czech Republic, where tunneling was a major fact of life for investors during the 1990s (ex. Coffee 1999, Johnson et al. 2003, Pajuste 2002). Other reporting agencies corroborate this view of Polish corporate governance. The World

Bank's "Doing Business Report" referenced in chapter 1 ranks Poland 38th globally in its protection of investors rights. This puts Poland considerably ahead of Hungary (113), Czech Republic (88), Lithuania (88), Ukraine (142), on par with Romania and Bulgaria, but behind Slovenia (18).

Not all reports are positive, however. Tamowicz and Przybyłowski (2006) note that Czech-style tunneling was indeed present on the Polish market during the 1990s, with notable companies such as Agros, one of Poland largest food producers, and Stomil Olsztyn and Stomil Dębica, two of Poland's largest tire manufacturers, being accused of funneling profits to their foreign owners, Pernod Ricard, Michelin and Goodyear, respectively. Bergloff and Pajuste (2005) note that enforcement lags significantly behind the generally good laws on the books.[51]

6.3.2 Pension Fund Influence on Hard Law

Most of the key political debates surrounding Polish hard law in corporate governance predates pension reform, and so it is unsurprising that the OFE pension system has not had a particularly large impact in this area. No pension fund professional, policymaker nor outside observer of Polish corporate governance that I spoke to noted any such political lobbying vis-a-vis hard laws on corporate governance. In terms of lobbying government on hard law matters more generally, the OFE pension system does have an industry wide lobbying organization, the Polish Chamber of Pensions (Izba Gospodarcza

[51] Bergloff and Pajuste find that Polish listed companies are significantly less likely than listed companies in other countries in Central and Eastern Europe to report ownership by management and boards of directors, total levels of executive compensation, and transactions with related parties.

Towarzystw Emerytalnych, or IGTE), which acts on behalf of 12 of the active pension funds. IGTE does not engage corporate governance matters as a lobbying issue. This may be because hard law on the subject reflects decision making in Brussels rather than Warsaw, because the pension funds don't care very much about corporate governance policy regardless of where it is made, or both. In either case, IGTE lobbies government and the regulatory bodies for changes in policies that affect pension fund management, such as the administrative fee schedule and portfolio composition rules. As I will discuss later, these issues have implications for corporate governance, but lobbying on corporate governance issues *per se* does not exist through the IGTE.

6.3.3 Corporate Governance Soft Law in Poland

Many of the changes in Polish corporate governance that have occurred since the pension system became an established part of the Polish political economy have happened at the level of soft law. "The Best Practices of WSE Listed Companies", which was adopted in 2007 and came into enforcement on January 1, 2008, is the most important part this soft law regime. The Best Practices of WSE Listed Companies is the most recent iteration of a set of corporate governance standards enforced through a "comply or explain" mechanism that was initially introduced in 2002 with the publication of "Best Practices in Public Companies in 2002".[52] The 2002 code was drafted by the Best Practices Committee of the Corporate Governance Forum, a group coordinated by the Warsaw

[52] Comply of explain refers to a process in which firms must submit annual reports noting whether or not they complied with a certain rule, and, if not, why. This format is quite common, having been pioneered by the Cadbury code in the UK.

Stock Exchange and comprised of lawyers, academics, representatives of Polish business groups (Business Development Institute and Lewiathan), the Warsaw Stock Exchange and PSEC.[53] Further iterations of the code published in 2005, and most recently in 2007 have been the product of a consultation process between the Corporate Governance Forum and various interested parties, organized by the listings department at the Warsaw Stock Exchange.

All three of the codes' iterations address four areas of corporate governance: general meetings, the supervisory board, the management board, and third party auditors. All three iterations mix very specific rules on some issues with more general guidelines on others, though the 2007 guidelines relegate some of the more general suggestions to a part of the code that is not subject to comply-or-explain. Because of the centralized ownership structure of the Polish firm, the most important corporate governance issue for minority shareholders is keeping the majority shareholders accountable to the financial best interest of the firm (Bebchuk and Hamdani 2009). The key mechanism for doing so is through the supervisory board and through the auditing process. Rules that provide for more independent supervisory board members, with more responsibility for more important tasks, and with definitions of independence that include relationships with the majority shareholder (as opposed to a focus on management) promote the rights of shareholders in a closely held firm. Accordingly, the composition and tasks of these bodies – supervisory boards and auditors – are among the most detailed parts of the best

[53] 2002 was something of a boom year for Polish corporate governance codes, as the similarly named Polish Forum For Corporate Governance, an academic institute affiliated with the Gdansk Institute for Market Economics also published "The Corporate Governance Code for Polish Listed Companies", which is commonly referred to as the "Gdansk Code". The Warsaw Stock Exchange and Polish Securities and Exchange Commission (now part of the KNF) both adopted the "Best Practices in Public Companies in 2002" as their own internal standard, so I focus my attention on this code.

practices code. The relevant rules across all three iterations are reported in table 6.2.

In some respects, the degree of shareholder protection embodied in these rules has increased over the three iterations, particularly as regards the audit committee and the definition of supervisory board independence, which currently mandates EC guidelines that preclude an independent supervisory board member from having a material relationship with a shareholder holding over 5% of company stock.[54] In other respects, standards have gone down, particular as regards the minimum number of independent supervisory board members, though it has been argued that the 2002 formulation that called for majority independent members was unrealistically ambitious and ill-suited to the reality of the Polish corporate landscape (Dzierzanowski and Tamowicz 2004).

The Warsaw Stock Exchange keeps close statistics of the comply or explain reports issued by Polish firms. While the raw data is confidential, I was authorized to reproduce summary statistics based on these annual reports. These data are listed in table 6.3. I note compliance with the most important provisions separately. For the purposes of comparison, I also report the level of compliance for all other aspects of the code. The number in each cell is the percentage of firms reporting compliance with the provision.

As can be seen, the high level of compliance overall stands in stark contrast to compliance with the most important, and most concretely defined provisions. From 2005 – 2007, compliance with the relevant portions of the best practices code increases for the number of independent members of the supervisory board, but remains relatively flat for the other provisions. Compliance with the noted provisions ticks up considerably for

[54] The EC standard for independence of supervisory board members that is now required is defined in Annex II of the Commission Recommendation of 15 February 2005.

Table 6.2 – Important Feature of the Best Practices Code for the Warsaw Stock Exchange			
Rule	**2002**	**2005**	**2007**
Supervisory Board			
# of independent supervisory board members	Majority	Majority; 2 if there is a majority shareholder	2
Definition of independence	Not stipulated, but should be laid down in the statutes of the company	should be laid down in the statutes of the company, recommendation to use EC standard	EC standard, plus disqualification of company employee or related party employee
Establish Audit Committee with independent board members	No	Yes	Yes
Establish Remuneration Committee with independent board members	No	Yes	No
Notification of Conflict of Interest	Yes	Yes	Yes
Third Party Auditors			
Approval by Supervisory Board	Yes	Yes	Not explicit, but implied by the supervisory board-organized audit committee
Auditors must be changed every...	5 years	5 years	7 years

Table 6.3 Compliance with the Best Practices Code for the Warsaw Stock Exchange				
Provision	**2005**	**2006**	**2007**	**2008**
independence of supervisory board members	23%	27%	29%	67%*
audit/remunerations committees established by supervisory board with independent board members	31%	32%	32%	63%**
auditor approved by supervisory board and audit committee	53%	52%	51%	nr
all other provisions	94%	94%	95%	91%
* note that the number of required independent members decreased and the definition of independence increased from the 2005 code ** note that supervisory boards are no longer required to establish remuneration committees in the 2007 code nr – not required				

2008, though this is likely more of a function of altered rules rather than improved corporate governance, given that compliance on other rules actually went down from 2007 to 2008.[55] The generally low compliance rates for the most important provisions suggests reasons to be skeptical that the increasing stock holdings of OFE pensions, and the widening portion of the Polish population that is invested in these funds have had the anticipated impact on Polish corporate governance. In practice, OFE pension funds have been marginally more active in lobbying for favorable changes to soft law than to hard law, but only marginally. At each point in which the code of best practices for WSE listed companies was revised, the listing department at the WSE engaged in a wide effort to solicit the opinions of market actors including major institutional investors. Members of the Best Practices Committee of the Corporate Governance Forum report no involvement on the part of the pension funds in the original drafting, despite having already been established as one of the major institutional investors on the Polish market. In the consultation process leading up to the drafting of the 2007 code, only one pension fund participated (PZU), though this participation appears to be a point of some pride on the part of that fund. IGTE does not appear to be active in soft-law corporate governance matters in any capacity. Reports of non-participation by pension funds was echoed by those involved in the drafting of the Gdansk code. On top of the lack of explicit pension fund input on corporate governance policy in Poland, there does not appear to an implicit

[55] One complication of interpreting comply or explain data is that, by definition, simply explaining a firm's non-compliance is, in effect, a form of compliance, though not one that is recognized in table 6.3 The actual comply and explain reports for many firms are available on their websites and there appears to be a significant amount of variation in the quality of the comply and explain reports. For example, some WIG 20 companies cite precise, firm-specific complexities as reasons to choose different arrangements on, for example, the composition of supervisory board. In other cases, the comply and explain reports submitted by WIG 20 companies suggest a more dismissive stance towards the standards suggested by the exchange.

impact through political re-prioritization towards more pro-shareholder corporate governance rules over this time period.[56] The Polish government has not taken the sort of vigorous steps towards higher corporate governance standards that the academic literature would predict. Many of my interview subjects cited ongoing problems in the corporate governance of state-controlled firms. The most closely attuned ministry to these issues, the Ministry of the Treasury, by virtue of its wide ownership in Polish firms and its almost complete ownership of the WSE, has not been an energetic force in favor of pro-shareholder corporate governance. Several pension fund professionals I spoke to expressed significant skepticism concerning Treasury's role or the WSE's role in corporate governance promotion, though the WSE has taken steps towards increasing awareness of corporate governance issues beyond its role in organizing the codes of best practice.[57]

6.4 Firm Level Pension Fund Activism

Every OFE pension fund executive I spoke to expressed their commitment to playing an engaged role as voters in the firms they invested in, and their belief that such a role was important to their own bottom line. ING is often held as an exemplar in this regard and has recently published a corporate governance code that presents guidelines for voting

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[56] This is not to say that the establishment of the pension funds have not had an impact on political decision making with respect to capital market operations. The supervision of the pension funds, first under the UNFE, then in a merged insurance-pension fund regulator, the KNUiFE, and now under the KNF, has been a considerable political issue, with the security of retirees' income being the most prominent factor. These issues, however, are at best tangential to corporate governance policy.

[57] Most recently, these efforts have included launching a corporate governance focused website http://corp-gov.gpw.pl/, through which investors and managers can learn more about the code of best practice, and learn about upcoming seminars nd conferences on the topic, many of which are coordinated by outside groups such as the Polish Directors Institute (Polski Instytut Directow, or PID).

and making their votes public. Other pensions report reliance on ISS voting recommendations, and such recommendations suggest a strongly pro-shareholder voting stance.

Beyond voting, every pension fund manager I spoke to underlined the importance of having independent members of the supervisory board and their commitment to using their position within the firm to place such members on the board. The funds were also clear that they did not feel it was appropriate (or wise) to attempt to appoint supervisory board members to serve as *de facto* representative of the pensions. Rather, as with their American counterparts, they prefer to choose supervisory board members that are seen as being truly independent, and they are often picked in consultation with management and majority shareholders. Pension fund executives often spoke of working with a relatively small group of professional board members whose independence and competence are generally accepted by the market. Pension fund executives I spoke to disavowed the notion that they should be involved in any way in the management of the firm. They see their role as purely to ensure the appointment of independent supervisory board members and then disengage with firm on a day to day basis. I found no evidence of any "name and shame" activities, wherein pension funds use negative publicity to pressure management. Of course, my questions had a clear "right" answer, and I wouldn't expect pension fund executives to claim indifference to the management of the firms they invest in. Non-pension affiliated observers of Polish corporate governance were decidedly more mixed in the their assessment of pension fund influence at the firm level.

The best way establish the impact of pension funds on firm level corporate

governance would be to note the statistical relationship between independent supervisory board members and levels of OFE ownership. However, I presently lack comprehensive data on the number of independent supervisory board members that would be useful to this end. Even if such data were available there would be no objective way to code the "true" independence of the nominally independent members. I can, however, evaluate the impact a bit more circuitously. The Polish Forum for Corporate Governance (PFCG), a think tank associated with the Gdansk Institute for Market Economics produced a series of corporate governance ratings for Polish corporations for several years in the mid 2000s.[58] The PFCG rankings run from 0 to 5, with 5 indicating the highest level of corporate governance. By comparing the corporate governance ratings of these corporations with the extent of OFE ownership I can get a sense of how much of an impact pension fund ownership has had.[59] In Table 6.4 I present data on corporate governance ratings and OFE ownership levels in 2003 and 2005, the first and last years of the PFCG survey. I include all firms listed in the year end WIG 20 in 2005 for which data was available.[60] These data are shown in levels as well as in differences. No strong pattern immediately emerges from the data. Contemporaneous pairwise correlations, as well as a pairwise correlations of differences reveal a positive, but statistically insignificant correlation between the corporate governance ratings and OFE ownership

[58] The Polish Forum for Corporate Governance is a different organization from the similarly named Corporate Governance Forum that drafted the best practice code

[59] I refrain from a more sophisticated regression analysis for several reasons. First, the decision to invest in a firm is likely endogenous to the extent of pre-existing shareholder-friendly corporate governance policies. Estimating a model in first differences, or using firm-fixed effects can adjust for initial conditions, but does not make the direction of causality any clearer. Absent an instrument that is correlated pension fund ownership by not firm level corporate governance, which has been elusive in quantitative work on the impact of ownership structure on firm characteristics, there is no obvious way to generate more conclusive quantitative evidence.

[60] I also analyzed data for a broader set of firms including non WIG-20 firms, and the same overall pattern, or lack thereof , emerged.

Table 6.4

Firm	PFCG 2005	2005 OFE ownership	PFCG 2003	2003 OFE ownership	Δ PFCG	Δ OFE ownership
Bank Zachodni	5	4.57%	4	7.22%	1	-2.65%
Agora	5	16.20%	4	20.06%	1	-3.86%
PKN Orlen	4	14.28%	2	19.57%	2	-5.28%
Bank Pekao	4	7.19%	3	10.09%	1	-2.90%
Kety,	4	39.90%	2	36.20%	2	3.71%
Computerland (Sygnity)	4	33.06%	3	34.00%	1	-0.94%
Telekomunikacja Polska	3	8.76%	3	10.04%	0	-1.28%
Prokom	3	17.77%	3	24.66%	0	-6.89%
BRE Bank	3	5.02%	3	1.92%	0	3.10%
KGHM	3	9.28%	3	12.61%	0	-3.33%
Softbank (asseco)	2	14.36%	2	10.08%	0	4.28%
Orbis,	2	19.86%	4	22.37%	-2	-2.51%
Netia,	2	1.62%	3	20.73%	-1	-19.11%
Average	3.38	14.76%	3	17.66%	0.38	-2.90%

levels. Spearman rank correlations yield similarly insignificant results. In other words firms with a high level of pension fund ownership do not appear to have more shareholder friendly corporate governance policies than firms without significant pension fund ownership. Neither is the expected relationship apparent in differences: increases in pension fund ownership do not appear to correlate with increases in corporate governance ratings.

Several interview subjects noted, with some frustration, that the OFE pension funds fail to do the most potentially powerful thing, which is simply to not invest in firms that exhibit poor corporate governance. This sentiment is echoed in the data. In Table 6.5, I compare the composition of the WIG 20 with the allocation of pension fund assets across those firms. If OFE holdings are influenced by the corporate governance of the firms they invest in, I would expect to see companies with poor ratings receiving less investment from the OFE funds than would be predicted by a company's stature in the WIG 20. I use the most recent, 2005 PFCG ratings along with the 2005 year-end composition of the WIG 20 and year end OFE pension holdings.

As can be seen, there is no clear relationship between a firm's corporate governance ranking and the extent to which pension funds own that share more or less than a firm's prominence in the WIG 20 would predict. The three firms that score best on the PFCG rankings are all under-held by the OFE pensions. The three firms that score worst among the WIG 20 are all over-held. In between there does not appear to be a consistent pattern. Pairwise correlations and Spearman's rank tests bear this out: there is no correlation between pension fund's enthusiasm for a stock and its corporate

Table 6.5

Firm	2005 CG rating	12/31/2005 Share of WIG 20	12/31/05Share of OFE investments	WIG 20 – OFE Holdings
BZ WBK	5	4.18%	2.70%	-1.48
BPH PBK	5	8.12%	7.31%	-0.81
Agora	5	5.06%	2.52%	-2.54
PKN Orlen	4	13.24%	21.88%	8.65
Kęty	4	2.01%	2.55%	0.55
Sygnity SA	4	1.91%	1.21%	-0.71
PEKAO	4	10.47%	11.95%	1.48
Mostostal Siedlce	3	1.21%	1.68%	0.47
TPSA	3	10.39%	16.40%	6.01
Prokom	3	3.98%	1.94%	-2.04
PKO BP	3	14.77%	12.95%	-1.82
KGHM	3	5.90%	6.61%	0.71
GTC	3	2.34%	3.72%	1.38
BRE	3	3.31%	1.40%	-1.91
Netia	2	4.69%	0.21%	-4.48
Orbis	2	1.14%	1.73%	0.58
Mondi (Świecie)	2	1.05%	1.77%	0.72
Dębica	1	0.97%	0.99%	0.02
Asseco	-	2.16%	0.48%	-1.69
Stalexport Autostrady SA	-	3.10%	0.01%	-3.09

governance ranking.

6.5 Why Isn't There A Larger Pension Fund Impact on Polish Corporate Governance?

Why don't OFE pension funds play a larger role in firm level corporate governance or corporate governance policy? My hypotheses suggest two possibilities: 1) the pension funds themselves are not big enough to escape free riding problems, and 2) they simply don't place much weight on corporate governance's impact on their portfolios to begin with. The former possibility seems unlikely. While I lack even a rough quantification of the financial gains from pension fund activism on the Polish market, several of the OFE pension funds have a considerably larger presence on the Polish stock market than the biggest, most activist funds in the United States have on the American market. Moreover, through the IGTE, Polish pension funds have been far more able to overcome collective action problems than their American counterparts.

It is the second possibility that seems more apt. One possible reason why OFE pension might not be sufficiently motivated by corporate governance is that there may be commercial conflicts of interest stemming from the corporate ownership of the fund administrators. A fund administered by ING, for example, may be less willing to push for concessions from management if the firm in question is itself a division of ING, or if another division of ING manages their corporate pension plan, or sells them an insurance product. This potential conflict of interest can easily percolate up to the policy arena. To alleviate that potential for conflicts of interest, the OFE fund administrators are banned from many kinds of communication with the other divisions of the sponsoring firm.

Moreover, no OFE is allowed to purchase shares in firms that are other divisions of the same parent firm, or if the sponsoring firm does substantial business with the firm to be invested in. So, for example, the pension operated by Bank PEKAO owns no shares in Bank PEAKAO, despite this firm being one of the largest components of the WIG 20 and the most commonly held stock in the OFE system. The efficacy of these measures in alleviating the potential for conflicts of interest were reinforced throughout my interviews. No interview subject suggested that corporate conflicts are a meaningful factor in pension fund behavior.

A second possibility are the incentives structures that tie pension fund administrators to the returns on their portfolios. OFE pension funds are not charged with a fiduciary duty, backed by potential legal sanction, in the same way as American pension funds are. Rather they are bound by a warren of regulations and market pressures, which, I argue, ultimately disincentivize the funds from placing weight on the potential gains from corporate governance improvements.

6.5.1 Performance Incentives, Herd Behavior and Free Riding

The sorts of performance incentives faced by funds managers are extremely important to understanding their incentives to become active in corporate governance issues. Are OFEs rewarded for high returns, penalized for low returns or both? The basic structure of the fees collected by fund administrators has stayed relatively constant since the original pension reform of 1999, and borrows heavily from the Chilean model. Each pension

fund is mandated to earn returns that are at least 50% of a weighted average return of all of the funds (weighted by their size), or 4% points below the weighted average, whichever is lower. If a pension fund fails to achieve these returns the administrator must pay the difference out of its reserve funds (1.5% of fees that are mandated to be set aside) or out of its own assets if the reserves are insufficient. Initially, the weighted average was calculated quarterly for a moving average of returns over the previous 2 years. The quarterly "beauty contest" forced pensions to carry relatively liquid equity portfolios allowing them to "lock in" returns by shifting assets to less risky securities (Stanko 2002, 2003). 2004 reforms to this law provides that calculations of the average return should be made every 6 months for a moving average of returns over a three-year span, which theoretically allows funds to avoid pressure to dump their equity holdings as frequently. Moreover, the new regulations limit any one pension's share in the weighted average to 15%. Thus far, only Bankowy has ever had to contribute funds to make up for a shortfall in returns.

While the penalties for under-performance are clear, the rewards for over-performance are considerably more ambiguous. Unlike hedge funds and some mutual funds, OFE pension fund administrators do not collect performance related fees. OFE pension fees are strictly a function of assets under management. Currently OFE pension charge a maximum of 7% in administration fees, though legislation currently being debated would bring that rate down considerably. In theory, if the fund's returns outperform its competitors, their reward is that their superior track record should yield more clients, and thus more of an opportunity to charge the administration fees. In

practice, however, this is not the case. Most OFE funds are operated by insurance companies, and the largest pension funds are those with the biggest preexisting network of insurance agents. A fund's ability to attract new members and new capital is only weakly correlated with returns, if at all (Kominek 2006).

Herd Behavior

The use of an internal benchmark, along with the severed connection between returns and attracting new subscribers, encourages herd behavior among asset managers whose primary concern is to avoid losses that might lower their returns relative to the weighted average return that could incur a penalty. To get a sense of how this behavior has presented itself over time, tables 6.6 and 6.7 show the allocation of OFE portfolios by asset class for the entire OFE system in 2002 and 2007.

Herd behavior across asset classes appears to have magnified from 2002 to 2007, despite changes to the calculation of the internal benchmark. This trend corroborates findings noted by Kominek. Zalewska (2006) also notes a strong clustering in the annual returns of OFE pensions. In 2007, there is scarcely any difference in the proportion of equity held by the various funds. This is particularly true of the large funds: Commercial Union, PZU and ING, which collectively control 64% of OFE pension assets, allocated 35%, 33% and 35% of their portfolios to equities in 2007, respectively. Some smaller funds do have slightly different stakes in domestic equity. Certainly OFE Polsat's 37% position in equities is a considerably bigger bet on stocks than Generali's 31%, but these

Table 6.6

2002 Portfolio Allocation Across Asset Classes

Fund	NFI Shares	Equities	Treasury bills	Bank deposits and bank securities	Bonds	Other investments
AIG OFE	-	0.27	-	0.02	0.71	-
OFE Allianz Polska	-	0.28	-	0.03	0.70	-
Bankowy OFE	0.01	0.30	0.06	0.05	0.58	0.00
Commercial Union OFE BPH CU WBK	-	0.31	0.03	0.03	0.64	-
Credit Suisse Life & Pensions OFE	0.00	0.28	0.01	0.09	0.62	0.00
OFE „DOM”	0.05	0.34	0.01	0.02	0.58	-
OFE {ego} (w likwidacji)	-	0.13	0.09	0.01	0.77	-
OFE Ergo Hestia	-	0.25	0.01	0.02	0.72	-
ING Nationale–Nederlanden Polska OFE	0.00	0.29	-	0.01	0.70	-
OFE Kredyt Banku	-	0.29	0.05	0.00	0.66	-
Pekao OFE	0.03	0.20	0.06	0.05	0.66	-
OFE Pocztylion	0.01	0.27	0.04	0.18	0.50	-
OFE Polsat	-	0.26	0.11	0.04	0.58	-
OFE PZU „Złota Jesień”	-	0.26	-	0.01	0.72	-
SAMPO OFE	-	0.23	-	0.04	0.73	-
OFE Skarbiec–Emerytura	0.01	0.12	0.23	0.03	0.61	-
Zurich OFE	-	0.30	-	0.04	0.66	-

Source: 2002 KNF annual report

Table 6.7

2007 Portfolio Allocation Across Asset Classes

Fund	NFI Shares	Equities	Treasury bills	Bank deposits and bank securities	Bonds	Other investments
AEGON OFE*)	0.00	0.32	0.01	0.03	0.63	0.01
AIG OFE	0.00	0.34	0.00	0.02	0.63	0.01
Allianz Polska OFE	0.00	0.34	0.02	0.03	0.60	0.00
AXA OFE*)	0.00	0.34	0.00	0.01	0.64	0.01
Bankowy OFE	0.00	0.32	0.00	0.02	0.64	0.01
Commercial Union OFE BPH CU WBK	0.00	0.35	0.02	0.03	0.59	0.00
OFE „DOM”	0.00	0.35	0.00	0.02	0.63	0.00
Generali OFE	0.00	0.31	0.00	0.07	0.62	0.01
ING Nationale-Nederlanden Polska OFE	0.00	0.35	0.05	0.00	0.59	0.00
Nordea OFE	0.00	0.35	0.00	0.02	0.63	0.00
Pekao OFE	0.00	0.36	0.00	0.04	0.59	0.01
OFE Pocztylion	0.00	0.33	0.00	0.02	0.62	0.02
OFE Polsat	0.00	0.37	0.06	0.01	0.55	0.00
OFE PZU „Złota Jesień”	0.00	0.33	0.01	0.03	0.62	0.01
OFE Skarbiec-Emerytura	0.00	0.33	0.00	0.02	0.65	0.00
Source: 2007 KNF annual report						

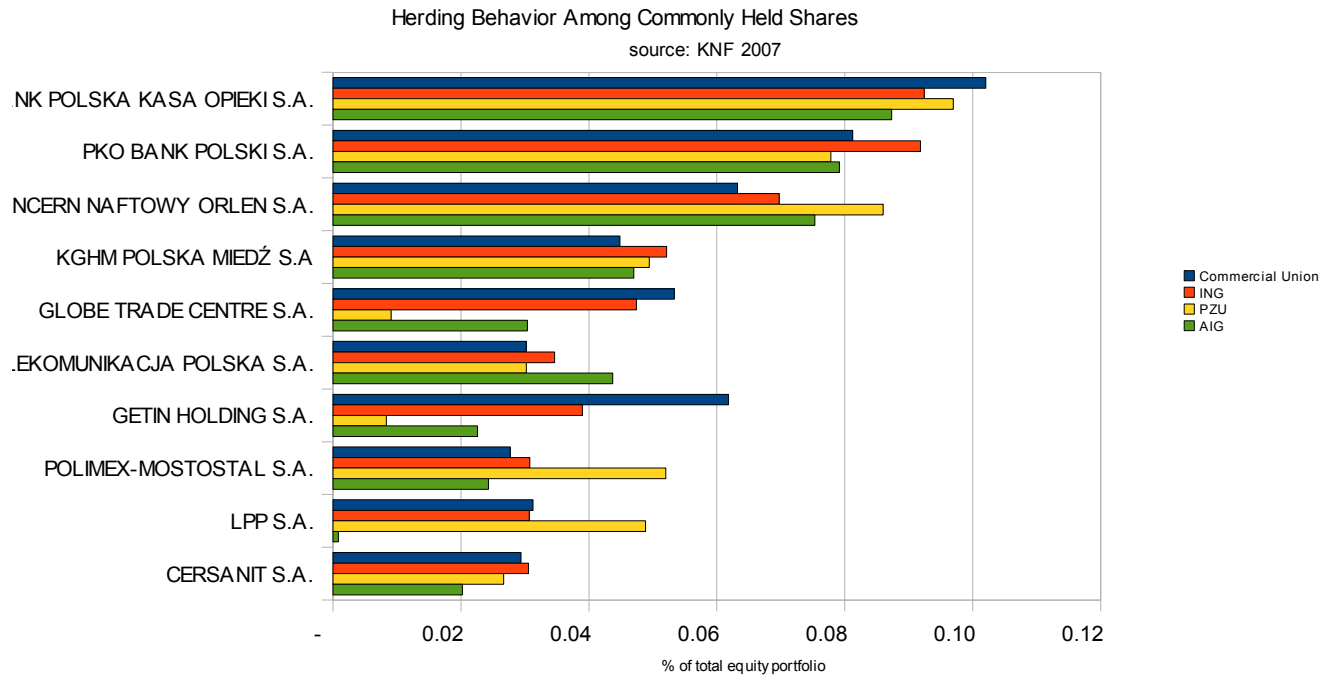
are minor players in the OFE market, as noted in Figure 6.2.

For savers, the implication of this herding behavior is a clustering of returns such that pensioners are not given an opportunity to choose better performing funds over worse.[61] For corporate governance, the implication is that no individual pension fund has a financial incentive to invest in the corporate governance of the market as a whole by lobbying for more investor friendly regulation or better enforcement of the legislation that already exists. The fruits of any such investment would only serve to move the weighted average return, but because the equity positions of all of the funds are so similar, the effect would be felt almost uniformly across the funds. Similarly, if the incentive is to increase returns in order to help marketing efforts, any move that also helped the competition would fail to do so. Because the OFE system is mandatory, it is unlikely that increased performance for the market as whole could attract more new savers into the system.

The herding across assets classes is mirrored by herding across individual stocks. Voronkova (2004) and Voronkova and Bohl (2005) both find a considerable degree of "feedback trading" wherein the trading strategies of one fund are mimicked by other funds. Even were it not for feedback trading, the large share of free float taken up by the OFE pensions, along with their preferences for large WIG 20 firms (in 2007, the 5, 10 and 20 most commonly held stocks accounted for 33%, 49% and 67% of total OFE equity holdings, respectively) all but ensure roughly comparable equity portfolios. To get a graphical sense of this behavior, Figure 6.3 shows the percentage of the four largest

[61] This effectively constitutes a waste of human capital. While one might expect some funds to have better managers than others, Kominek finds that there is no persistence in pension fund performance over time

Figure 6.3


Herding Behavior Among Commonly Held Shares
source: KNF 2007
NK POLSKA KASA OPIEKI S.A.
PKO BANK POLSKI S.A.
NCERN NAFTOWY ORLEN S.A.
KGHM POLSKA MIEDŹ S.A
GLOBE TRADE CENTRE S.A.
.EKOMUNIKACJA POLSKA S.A.
GETIN HOLDING S.A.
POLIMEX-MOSTOSTAL S.A.
LPP S.A.
CERSANIT S.A.
-
0.02
0.04
0.06
0.08
0.10
0.12
% of total equity portfolio
Commercial Union
ING
PZU
AIG

OFE equity portfolios – Commercial Union, ING, PZU and AIG – taken up by each of the 10 most commonly held shares in the year 2007. As can be seen, the larger funds - ie those funds with large enough equity portfolios that they could potentially justify corporate governance activism on financial terms - typically hold the same shares in roughly the same proportion. While there are some exceptions – AIG holds surprisingly little stock in LPP SA, for example – there are no firms in which only a single large OFE fund has a large investment relative to its total equity portfolio.

This clustering effectively means that incentive problems also exist at the firm level. The payoff on a significant investment in the corporate governance of any single firm, even if it yielded higher long run returns that were larger than the investment in corporate governance activism, would be mirrored more or less equally in the returns of all of the largest funds. There would be no way to use this strategy as a means of making a fund more attractive to potential enrollees, even if there were a significant relationship between fund performance and attracting new clients.

Beyond a cursory comparison with US pension funds, empirically rigorous evaluation of whether these incentive structures are in fact driving the curiously non-existent corporate governance activism in the Polish case is difficult, not least of which because the internal benchmark used to evaluate minimum returns has not changed sufficiently over time to expect concurrent changes in behavior. Moreover, the use of such a benchmark is a common feature of most pension reforms based on the Chilean model. The only partial exceptions that I are aware of are Hungary and Colombia. Beginning in 2003, Colombia changed its minimum return guarantee to be based half on

a weighted average of pensions operating in Colombia and half on an external benchmark of returns on a synthetic portfolio of long-term assets designed by the Colombian regulators. This policy shift reduced herding somewhat among Colombia's pensions, though a high degree of herding remained (Rudolph et al. 2007). The Hungarian minimum return guarantee is set to a benchmark of government bonds, requiring pension to earn 90% of that benchmark or make up the difference out of their own funds. This system was also designed to reduce herding behavior among pension funds.

By moving towards an external benchmark, we might expect that there should be more corporate governance activism by pension funds at the policy level, as all funds have an incentive for domestic equity returns to increase. However, due to the heavy reliance on fixed income assets in the calculations of these external benchmarks, and the underdeveloped (relative to Poland) stock market in both countries, neither pension system invests heavily in domestic stocks (roughly 10% in both countries, despite a statutory limit of 50% in Hungary and 30% in Colombia), and neither has played a significant role in corporate governance.

6.5.2 Limits of Foreign Investment and Government Incentives to Retain Pension Fund Capital

A remaining question is: Why hasn't the Polish government done more to promote corporate governance? Hypothesis 1 can provide some insight into this puzzle. Poland's current regulations stipulate that pension can manage a portfolio with the limits on investment in any particular asset class shown in Table 6.8. Table 6.8 also shows the

Table 6.8

Asset Class	Percentage in 2007 OFE portfolio	Statutory Limit
Bank Deposits and Securities	2.52	20
Domestic Equity	34.01	40
NIF	0.27	10
Mutual Fund Shares	0.23	10
Corporate Bonds	1.28	5
Other Fixed Incomes	0.37	15
Foreign Investment (Debt, Equity, Bank Deposit	1.04	5
Public Debt (Polish Treasuries, Municipal Bond	59.98	no limit
Other	0.3	

aggregate portfolio of OFE pension funds from the year 2007. As can be seen, Polish OFE's have a strong appetite for shares, but as a whole tend to be considerably more cautious in their portfolio than statutes require, particularly with respect to foreign investment. Part of the reason is that the restrictions on foreign investment are more stringent than they appear, for three reasons. First, OFE pension funds are severely limited in the derivatives that they can hold, and are presently unable to hedge foreign equity purchases with currency based derivatives. In the absence of this ability, foreign investment requires making a directional bet on currency movements as well as stocks and this is simply too risky of a bet for pension funds to take on. Second,Table 6.8 funds must pay transaction fees on foreign markets out of their own funds when such fees are higher than those on Polish markets. Because foreign transactions are often more expensive than trading on the domestic market, pensions are discouraged from making these investments. Finally, a 2003 Ministry of Finance issued a rule mandating that foreign investments be limited to instruments with an investment grade rating. This effectively limits pensions to foreign investments in bonds, which are routinely rated, but not stocks, which are rarely rated.

By restricting the amount of foreign investment so severely these regulations effectively creates a captive investor. Claessens, Klingebiel and Lubrano (2002) suggest that such a captive investor is less likely to engage in corporate governance activism at home. This strikes me as a misguided concern. By ensuring that the OFE pensions have a stake on the domestic market, the limitations on international investment ensures that they can't take the “wall street walk” with respect to the entire market in order to avoid

Polish corporate governance altogether. Certainly in the American experience, pension funds became active in firm-level corporate governance affairs partially *because* they became captive investors through self-imposed indexing strategies and when their equity positions became too large to sell without depressing share price. I see little evidence that the ability of limitations on foreign investment to create "captive" pension funds should have a deleterious effect on pension fund activism, and, if anything, may induce the opposite behavior.

The primary concern of creating captive pension fund assets is that it undercuts government motivations to use corporate governance policy as a way of retaining investments. In the Polish case, the need to keep pension fund money at home in order to finance long-term growth and capital accumulation is a long standing priority, even if achieving it comes at the likely expense of savers' long term returns. If achieving this end were at least partially tied to implicit or explicit demands for better corporate governance policies or, as is more likely, more active enforcement of laws already on the books, it seems likely that such reforms would follow. Instead, this end is effectively guaranteed through legislation.

6.6 Conclusion and Recommendations

OFE pension funds play a modest role in Polish corporate governance, primarily through their insistence on promoting independent supervisory board members in the firms they invest in. Even there, however, there is a paucity of evidence that these efforts have been

fruitful in the aggregate. OFE pensions do *not* play a significant role in shaping policy, either directly by participating in the rule making process or indirectly by shifting political priorities. OFE pensions do *not* engage in name and shame efforts, or attempt to insert themselves in the business affairs of the firms they invest in.

Why have the corporate governance efforts of the OFE pension funds been so anemic compared to their American counterparts? I have argued that the regulatory structure faced by OFE pension funds is largely responsible by decreasing OFE pensions' incentives to expend resources on corporate governance issues and by insulating government from the effects of capital flight. Several regulatory changes that are being currently debated by the Polish government or have been proposed by IGTE that could alter this dynamic. One of the more important of these reforms is the expansion of overseas equity investment through 1) lifting the current 5% ceiling, 2) allowing OFE pension funds to hedge overseas investment with currency derivatives, 3) lifting the ban on unrated overseas securities, and 4) reforming the rules concerning transaction fee payments. This reform, if it is pursued to the extent suggested by IGTE, would culminate in a 30% cap on overseas investment by 2015 and would have far reaching effects on the sorts of portfolios held by the pensions. Consequently, it could change government attitudes towards corporate governance if the retention of pension fund assets continues to be a major priority. Moreover, without an opportunity to shift assets overseas, the continued accumulation of pension fund capital on the Polish capital markets will only strengthen the correlation between the equity portfolios of the different funds. To this end, I suspect that the persistence of such severe limitations on foreign

investments will exacerbate free riding and further disincentivize OFE pensions from acting as corporate governance watchdogs of the firms they invest in.

A pending law suit by the European Commision to liberalize these rules to conform to the 30% standard set for European private pensions would, if successful, force this policy change. However, the reactions by the Polish government to this suit have only underlined the government's commitment to keeping these limitations in place for the foreseeable future. Of course, the corporate governance implications of potential capital flight have to be weighed against the other, more immediate implications for the domestic economy and I am in no position to evaluate those economic needs. Nonetheless, I do recommend that a long-term, holistic view of the matter including consideration of its corporate governance implications should be taken.

A more likely reform would be to move away from an internal benchmark and replace it, over time, with an external one. There are a variety of ways to construct a system of external benchmarks, and suggesting one mechanism over another is outside of my expertise and outside of the scope of this dissertation. However, constructing an external benchmark, if it leads to less herd-behavior among pension funds, could encourage OFE pension funds to take more responsibility for the corporate governance of the firms they invest in. Moreover, even if an external benchmark does not reduce herd behavior, it provides a motivation, currently lacking, for pension funds to engage in corporate governance issues that impact the market as a whole through lobbying for better enforcement of corporate governance rules, or by taking a more active stance in ongoing soft law efforts to strengthen Poland's corporate governance regime. Taking

steps to strengthen the relationship between fund performance and attracting new enrollees might also serve, in conjunction with the above reforms, to strengthen this motivation.

Chapter 7 Conclusion

What are the politics of corporate governance? Culpepper has argued that the politics of corporate governance and securities law are fairly simple: managers and inside shareholders are the most powerful and most engaged interest group and therefore almost always get their way. There is some truth to this, but it leaves much unexplained. Some corporate insiders face a legal system that empowers minority shareholders in the firm, allows for an active market for corporate control, curtails their ability to self-deal and promotes boards of directors that are at least nominally independent.

I have argued that the conditions under which management loses are fundamentally determined by politics. Management will lose more often when shareholders have a lobbyist of their own, which in turns falls on the existence of pension funds that are sufficiently incentivized to play that role, when economic outcomes are particularly sensitive to corporate governance policies, which I argue can be rooted in the threat of capital flight to foreign markets or the extent of shareholding among the public, and whether the electoral system is designed in a way that increases political accountability to the public interest. I have demonstrated the validity of my hypotheses across three different sets of empirical tests. In chapter 4 I examined the global spread of insider trading laws and shareholder voting rights. In the context of insider trading laws I found overwhelming evidence that governments will be more likely to adopt and enforce insider trading laws when 1) they face reelection under relatively majoritarian electoral laws that magnify political accountability to macroeconomic outcomes, and 2) they face competitive pressures from peer state that have adopted insider trading laws. Consistent

with my hypotheses, I also find an interaction between electoral laws and competitive pressures such that the impact of one factor is greatest when the others factor is less present. Finally, to the extent that countries that experienced hyperinflation prior to establishing their national pension systems is a valid proxy for the presence of a pension system that can act as a shareholder lobby group, I also find the presence of such a lobby increases the likelihood of enforcing insider trading laws. I find similar results for shareholder voting rights, though there I do not find any evidence of competitive diffusion.

In chapter 5 I examined the role of American pension state public employee retirement systems, in corporate governance debates in the United States during the takeover era of the 1980s. My chief argument in this chapter is that pensions need to be able to overcome barriers to collective action to play a significant role in corporate governance matters. Because efforts to coordinate corporate governance activism and lobbying among American pension funds have been limited, this effectively means that American pension funds need to be large enough to overcome collective actions internally by owning enough of the market that the expense of their efforts to improve corporate governance will be offset by rises in the value their own portfolios. This hypothesis conforms to reality. Only the very largest pension funds have engaged in corporate governance activism at the firm level. I similarly find that the key factor explaining variation in the spread of antitakeover laws is the size of the equity assets of state pension funds. Because the state retirement systems do not contribute money to political campaigns, it is more likely that their impact on policy outcomes suggests that

the exposure of politically sensitive pension funds assets to the stock market leads politicians to internalize shareholder value as a part of their own political self-interest

In chapter 6 I explored the role of Polish pension funds in that country's corporate governance regime. Relative to their American counterparts, Polish pension funds are larger and more organized. If overcoming barriers to collective action were a sufficient condition for pension fund activism, I would expect to see a high degree of corporate governance activism among these pension fund. This turns out not to be the case. I argue that the key to understanding why lies in the regulatory structure and competitive pressures that motivate Polish pension funds. Whereas American pension funds are primarily focused on returns to savers (motivated in large part by their legal roles as fiduciaries) Polish pension funds are not legal fiduciaries and are incentivized by regulation to maintain returns above the industry average. Because of a high degree of herd behavior among Polish pension funds, there a few incentivizes for any individual fund to invest in efforts that promote corporate governance measures that would only raise the internal benchmark rather than promote the interests of that fund.

7.1 Outstanding Issues

The agenda for corporate governance research in political science going forward is rich. To conclude this dissertation I will note several particularly prominent questions that still need to be answered.

Issue 1: Bureaucratic Models Of Corporate Governance. In the model presented in chapter 3 and the statistical tests in chapter 4 and chapter 5 I have examined corporate governance policies that are made in the legislatures. Indeed, most corporate governance policy in most countries is made by legislatures and therefore models that feature law-makers as the agents of voters and special interest groups are appropriate. However, many of the most important corporate governance policies are crafted outside of the legislature, in regulatory bodies such as the SEC. Two question immediately arise: When will politicians delegate corporate governance policy to the regulatory agencies? And, What role does regulatory capture play in corporate governance decisions? To address these questions we will have to develop (or appropriate from other sub-disciplines) models of bureaucratic behavior to apply to corporate governance questions.

Issue 2: Quantitative Measures of Corporate Governance. As noted in chapter 4, most of the extant literature uses a measure of corporate governance - La Porta et al.'s shareholder protections – that is not particularly useful for comparisons across countries with different ownership structures and is constructed in a way that makes testing political economy models difficult. I have argued that insider trading laws provide a solution to many of these problems, but insider trading laws are a very small part of the corporate governance landscape, and, arguably, not a particularly important one. More data collection is needed for a wider variety of variables than is currently available.

Issue 3: IFIs and Corporate Governance. Following the Asian financial crisis, the IMF

and World Bank began promoting corporate governance reform, and the IMF began to include corporate governance issues as part of their loan's conditionality. No study I am aware of looks at the impacts of these efforts. Incorporating IFIs into the corporate governance picture would be a useful addition to the literature.

Issue 4: Will We See International Corporate Governance Standards? In the 2009 G8 meeting the participants produced the "Lecce Framework", which covers a wide variety of topics, including accounting standards, financial disclosure rules, credit rating agencies and other topics, all aimed at "better protecting investors, and strengthening business ethics". Currently, the G8 groups is working with international organizations including the IMF, World Bank, FASB, IOSCO and others to add firmer detail to the framework. The question is, will the Lecce Framework become something more than the OECD's widely cited, but ultimately non-binding corporate governance guidelines? Perhaps not, as it is hard to imagine the US going along with an international regime in this area. Other countries, on the other hand, whose investors' money is often invested in financial centers in New York and London would certainly like greater input into the corporate governance of firms located there. Whether through the Lecce Framework or some other mechanism, the question of whether internationally standardized corporate governance rules are feasible or desirable is likely to be an ongoing source of debate and a potentially illuminating opportunity to apply international relations theory to corporate governance.

Issue 5: The Role Of Campaign Finance Laws. At the heart of my theory is the political giving by corporate insiders. Certainly in the United States, this giving is massive, typically taking the form of contributions from national organizations like the Business Roundtable and US Chamber of Commerce, but also involving local and state level organizations with a similar set of policy preferences. However, the role of money in politics varies considerably across countries, and the incredibly permissive legal environment in the US is unique (and may be why the United States is unique among Anglo-American countries in its restrictive policies surrounding proxy access). While I was able to control for (to some degree) the permissiveness of campaign finance law at the state level, no such database exists on the cross-national level. Developing and incorporating this data into statistical tests similar to those used in this dissertation would be a helpful area for future development.

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