

CONFLICTS OF INTEREST AND THE POST-2000 MARKET DOWNTURN

Introduction

Since early 2000, international capital markets have undergone one of their most wrenching corrections in a generation. The major stock exchanges fell 40 per cent between their early 2000 peaks and the troughs reached in late 2002 or early 2003. Meanwhile, the “growth exchanges”, which specialised in high-tech companies, fell much more, with many of these exchanges becoming illiquid or simply closing. Meanwhile defaults and downgradings of corporate debt rose to near record levels and spreads on lower rated bonds approached record highs. Insurance companies and pension funds, which had large exposures to equities and bonds, experienced a perceptible decline in balance sheet quality.

The repercussions of this downturn are being felt more widely than earlier corrections. Mainly due to the rise of mass ownership of institutional savings in the past two decades, the number of individuals who are affected by the adverse market conditions is larger than ever before. Simultaneously with the drop in markets, a number of events have shaken the confidence of investors, the general public and legislators in the fairness and transparency of the capital markets. The loss of confidence in capital markets represents a potentially serious threat to the prospects for renewed capital markets growth.

In the past, the public and legislators in many countries often had tended to see the capital markets as unstable, speculative, vulnerable to manipulation and unfair to small investors, and thus little effort was made to build systems that were equitable to small investors. It was often felt that participation in the capital market was a matter of concern for insiders or for individuals with large amount of discretionary income that could be placed at risk in the markets.

Through the late 1990s, however, the public as well as policy makers had become convinced that the reforms of the 1980s and 1990s, including legislative changes to promote the development of capital markets and upgraded regulation, had markets fairer and more transparent while the growing presence of institutional investors had added greatly to professionalism in markets. Partly as a result, intermediation through the capital markets displaced bank led intermediation to a considerable degree while the public held an increasing share of its financial assets in the form of direct holding of securities or indirect holdings via institutional savings. A number of countries introduced structural reforms to promote development of their capital markets. Thus, Germany which had been cited as the prototype of a bank-dominated financial system introduced a series of laws designed to stimulate the growth of the capital market. Simultaneously, policy makers accepted the notion that, financing difficulties on pay as you go pension systems had made it imperative to introduce pension reforms under which the capital markets would have to shoulder a larger share of funding of retirement income in the future.

Confidence in the capital market was closely linked to the market-based system of corporate finance and corporate governance that gained pre-eminence in OECD countries in the 1990s. In defense of the superiority of the capital markets model, it was argued that institutional investors, through active trading of their portfolios and/or use of ownership rights, had devised means to align the interests of management and shareholders and thus to hold management accountable for producing “shareholder value.” The superiority of the market based system of governance seemed vindicated by gains in corporate profitability and rises in equity prices in the 1990s in countries that had adopted this model, especially the United States and United Kingdom. Trust in the capital markets based system also reflected the faltering performance of economies that had used more bank-centred consensual governance models, such as Japan and Germany. Many analysts attributed the lagging performance of other governance models on the inability of such systems to focus the company clearly on any objective.

In the realm of the real economy, vastly exaggerated claims were made in the name of the “new economy” paradigm which supposedly altered the character of the business cycle and permanently raised the sustainable rate of long run growth. While it is true that significant gains in productivity related to technology were made, the new economy paradigm was used to justify investment in telecoms and Internet that appeared unjustified using traditional measures of prudence. The new economy paradigm and the presumption that capital markets had achieved qualitative gains in efficiency were used to justify equity valuations that were out of proportion to historical norms.

The past three years have shaken confidence in almost every one of these presumptions. Events have shown that corporate management was often able to manipulate board structures or audit procedures while introducing remuneration policies that served the interest of senior members of incumbent management to the detriment of other employees and shareholders. Incumbent management was also able to provide incomplete or deceptive information despite internal safeguards and despite requirements for disclosure by stock exchanges and regulators. Partly because self-regulation of the accounting profession had allowed substantial leeway in the use of reporting standards, accountants and auditors were able to misrepresent the actual financial state of companies. Moreover, in many cases boards, auditors and accountants were not legally liable for failure to monitor management effectively.

After information was disclosed, it was often not critically examined nor were faulty assumptions challenged. It was fairly common for research by intermediaries to be biased so as to facilitate business development efforts operations by affiliated institutions. Similarly, there is credible evidence that institutions engaged in both commercial and investment banking may have abetted the concealment by some corporations in producing deceptive information in order to protect activities of related firms.

Other weaknesses in the process of oversight by the market involved fewer apparent conflicts of interest, but nevertheless lessened trust in the capital market as a means of enabling investors to be sure that management was in fact providing credible information or pursuing their interests. It is noted that the timeliness and accuracy of analyses of the ratings assigned rating agencies have often followed the market rather than provide reliable guides to future credit problems. Asian countries remained relatively high until the Asian crisis of 1997 was already advanced while Enron was rated investment grade until shortly before its collapse.

Overall, it is now plain that the system contained opportunities to abuse agency relationships and misalignments of interest. The current process of reform consists of identifying pace where agency relationships become distorted and finding means to remove those distortions while seeking better means to align the interests of final investors and those of other market participants.

Conflicts of Interest in Capital Market

The present downturn occurs after a long cycle during which capital markets have been displacing banks in financial intermediation. Since banks typically retained most risks on their balance sheets, they have strong incentives to engage in strict monitoring of borrowers and to obtain necessary credit information through public channels or through private contacts with borrowers. On the other hand individual depositors in banks have little need to oversee the detailed distribution of credit by banks, since their return is not directly linked to the return on any particular bank credit. Depositors without official insurance need only concerned with the overall solvency of the bank while insured depositors may even ignore this consideration.

In capital market intermediation, by contrast, investors have a strong incentive to scrutinise every transaction, since their return depends on the worth of specific transactions and the market is constantly repricing all assets. At the same time, the functions of business development, information-gathering and

risk-bearing, which were all previously performed within the bank, are now dispersed among several parties, each of whom must be trusted to act as agent for other participants, and each of whom is subject to conflicting pressures. The fact that a growing number of operations are potentially subject to market scrutiny and that investors have a powerful incentive to monitor operations carefully means that the capital markets can in principle be effective monitors of economic performance than banks and thus can enhance economic efficiency. At the same time, the disaggregation of function in the capital market implies that the effective functioning of the system requires measures to align the interests of the various participants.

The fact that over the years, various market participants have abused agency relationships and that market participants and regulators are constantly challenged to find equitable rules of the game suggests that such conflicts of interest are inherent in the investment process. Indeed, it is fair to say that the detection and prosecution of breaches of agency relationships is central to the conduct of capital market regulation to a far greater degree than to any other form of financial regulation.

Efficient intermediation through capital markets presupposes an effective system of mechanisms to make corporate management amenable to discipline by the market. There must be strong incentives for the corporate sector to disclose reliable information. Reliable disclosure involves the internal governance procedures of the corporation as well as the regulatory regime established by self regulatory organisations and market supervisors. Those responsible for processing and disseminating disclosed information (financial intermediaries and rating agencies) must have strong incentives to analyse information rigorously and to provide investors with the most objective advice possible.

The degree to which agency relationships have been abused in recent corporate scandals spans a wide range. Some of the more egregious cases may have involved criminal misrepresentation which can be punished under laws. Other lapses, for example cases where Chief Executives auditors or boards were successfully able to claim ignorance of doubtful accounting practices may not be illegal but may highlight the need to clarify laws or to fill in legal or regulatory gaps. In the cases of conflicts between brokerage and research, agreements have been reached under which mechanisms to separate the reach and investment banking functions at investment banks and to provide more independent research. In the United States, related settlements have also included cash payments. In other cases, there may be no clear evidence of an abuse of an agency relationship, but where there is nevertheless some doubt as to whether certain market participants have exercised their monitoring function as well as can be expected. In this connection, the rating agencies and institutional investors deserve special mention.

Many of the reforms to address shortcomings identified in the past three years fall into the realm of corporate governance. In the United States, major revisions are taking place in corporate law have been undertaken under the Sarbanes Oxley law which seeks to clarify the responsibility the accountability for various corporate officers and for auditors. This is part of a wider process of reviewing basic measures related to corporate governance, such as the role of auditors, the rights of shareholder. As a result of these reforms, the accounting and auditing professions will be targeted to a higher degree of public oversight than in the past. This note will not discuss the situation of corporate governance in detail, but will instead focus on agency problems in entities that are directly active in capital markets.

Financial Intermediaries

A number of serious conflicts have appeared in investment banks, whose main revenue consists of fees from new issues and M&A. One of the conflicts stems from the fact that the investment banking industry is also the main supplier of research to investors. Investors recognise that the investment banks have strong motivations to present data that support business development efforts and thus typically discount all their recommendations at least one notch. Even allowing for some understandable tendency

toward optimism, it is likely that investment banks developed compensation structures and business models that subordinated investment research to the marketing objectives of the bank.

One of the techniques allegedly used by the investment banks in diminishing the willingness of investors to resist aggressive business promotion efforts was the use of favourable terms to participate in IPOs. In the booming pre-2000 conditions, IPOs tended to price new equity issues, particularly on high-tech companies, at less than their eventual secondary market prices. In order to be included in future IPOs, investors had strong motivations to ingratiate themselves with the investment banks. In order to rebuild credibility with investors and forestall further regulatory action, the industry is seeking to introduce reforms to strengthen the firewalls between research and marketing.

Private actions are being reinforced by actions on the official side. In the United States, the SEC in May 2002 issued rules concerning the ways in which investment banks should organise and structure compensation to minimise such conflicts of interest. In December 2001, a Global Settlement has been reached among state attorneys general, the SEC and major investment banks. This settlement includes 1) compensation for investors who may have been damaged by research provided by investment banks 2) agreement by the investment banks to strengthen institutional separation between research and investment banking and 3) payments by the investment banks to support independent research and investor education. Rules to limit aggressive IPO techniques were also adopted. In the United Kingdom, the FSA has also taken action to address the need to deal with these problems. In July 2002 a Discussion Paper on these issues was released. The FSA began to clarify its position on how these conflicts should be resolved and sought further comments. IOSCO Technical Committee has formed a working group to formulate principles of analysts' conflict of interest.

The current downturn has also revealed possible conflicts between commercial banking and investment banking. In the case of Enron, for example, some commercial banks may have assisted the company in concealing unfavourable information. In order to preserve investment banking business for the parent company, these banks may have assisted Enron in deceptive practices. A number of reforms have been introduced in Member countries to address these conflicts of interest.

Credit Rating Agencies

Rating agencies have been operating in the United States for a century. They traditionally issued ratings issued by corporations, states or municipalities and more recently sovereign borrowers. Their credibility rested almost entirely upon the confidence that investor placed in their judgment. The role of rating agencies has grown considerably as capital markets have gained in intermediation and as business became more international in scope. As borrowers who had been accustomed to placing their debt with domestic investors placed debt overseas, international investors found the use of ratings by established and trusted agencies to be useful.

Rating agencies have come under some criticism in recent years. In particular, it is alleged that the agencies have often been slow to identify credit problems, often following market developments rather than highlighting upcoming difficulties. For example Asian crisis countries continued to be well rated until the 1997 crisis was well advanced, and Enron was rated investment grade until shortly before it collapse.

Traditionally the rating agencies simply provided a rating which the issuer used when accessing the markets, but the business model of the rating agencies is evolving away from simply offering opinions on existing borrower which market participants are free to accept or reject. Agencies derive a growing share of their revenues from structured transactions. In these operations, the agency does not simply offer its judgment about an existing credit but participates with the originator of the deal in advising on what features are necessary in order for the credit to receive a targeted rating. Additionally, a large share of the

revenue of rating agencies comes from issuing opinions about the legal robustness of credits and in the process of obtaining legal opinions that indicate the legal standing of certain features of the operation.

At the same time, the agencies have achieved growing official recognition. In the United States since 1975 the ratings of Nationally Recognized Statistical Rating Agencies (NRSRAs) have achieved significant recognition by the SEC, bank supervisors and other official bodies in calculating certain ratios or in otherwise categorising the credit quality. Similarly, the Basle II capital requirements for banks envisage an expanded use of ratings in setting capital requirements. As part of the Sarbanes Oxley Law, the SEC undertook a global assessment of the role of rating agencies in capital markets. An initial report was published in January 2003.

Conflicts of Interest in Institutional Investors

One key group of market participants whose role in the financial market is undergoing increasing scrutiny is the institutional investors, i.e. insurance companies, pension funds and collective investment schemes (CIS). Although retail investors have some significance in all markets, the rising exposure of the public to the capital markets over the past 20 years has mainly come in the form of institutional savings. Institutional savings products offer the retail investor access to professional portfolio management diversification and low cost execution, enabling the individual to execute fairly complex investment strategies that were previously only available to wealthy and sophisticated individuals or large institutions. These products can be tailored to the individual's financial goals and risk tolerance, and the individual can select the desired balance of self direction and external financial counselling. For institutional investors to maintain confidence they must convince the public and of legislators that they are in fact acting as reliable agents of final investors. However, since in institutional investment a large number of smaller investors with limited monitoring capability entrust their savings to professional fund managers, there are numerous possibilities to exploit the agency relationship to the detriment of final investors.

Because CIS are the form of institutional investment that fall directly within the purview of securities regulators, this text will focus on CIS, but in some cases the generalisations made about CIS will apply to other forms of institutional investment as well. , there are great complementarities among the various forms of institutional savings. Thus insurance companies have had success marketing variable annuities which combine many of the features of CIS with insurance guarantees and contain some of the tax advantages of insurance products. Similarly, CIS are well suited to defined contribution DC pension schemes. Fixed annuities, which are offered by insurance companies, are a useful tool for planning retirement income. Likewise, financial service firms often seek to offer packages of institutional investment products, such as CIS, pension and insurance products along with financial counselling in order to meet the customer's full range of requirements. Financial groups offering CIS to retail investors will often solicit mandates from pension funds to manage assets. The portfolios managed in both cases will be very similar.

Reflecting booming capital markets as well as the confidence of the public that institutions could be trusted to act on their behalf, the public has accumulated assets in the form of insurance products, pensions or collective investment schemes (CIS) which in turn invest those assets. Financial institutions have targeted institutional savings and asset management as an activity with especially high growth potential, partly because private markets are expected to assume an increasingly large role in funding retirement income.

Recent Revelations in the CIS Sector

Over the past few years, OECD countries have been strengthening their legal and regulatory frameworks for CIS. Laws governing CIS have been introduced or improved while several countries have launched pension reforms. The EU has made efforts to develop pan European markets in CIS, as well as making progress in enlarging the European markets in pensions and insurance. Meanwhile, private firms active in institutional investment upgraded skills, enhanced capacity introduced innovative products. In the past two decades the institutional investors have made important strides in gaining trust among the general public and legislators. At time, the institutional investor sector has been subject to periodic criticism. Insurance products have often been criticised for lack of transparency undue complexity and hidden costs.

Likewise, CIS have sometime come under criticism for their high fees and inability to outperform indices. In Europe three decades ago, cases of fraudulent marketing appeared which led many countries to introduce strict legal frameworks for CIS but with these reforms the industry was cases of fraud the industry's record has been good.

The most serious allegations of misdeeds have surfaced in the United States, the largest and longest established CIS industry in the world and one where it was believed that the industry was perceived strongly committed to its fiduciary duties to investors. Indeed until the current wave of scandals erupted, spokesmen for the mutual fund industry would regularly say that the investment management industry has been comparatively free of the large scandals agency relationships that have come to light periodically in other parts of the investment industry. In subsequent months, however, major US mutual funds were shown to have tolerated unfair, and sometimes outright illegal, tactics such as market timing or "late trading." In other words, despite the system of independent directors in US funds, and despite continuing oversight by the SEC, major mutual funds were able to pursue trading practices in which the interests of smaller investors were ignored in favour of those of larger players which were able to trade on terms not available to retail investors. While measures to sanction serious allegations have only been initiated in the USA, several countries in Europe have quietly launched investigation to see whether CIS in their markets have been following similar practices.

Inherent Agency Problems in Institutional Investors

It is unclear to what extent US mutual fund companies engaged in the kinds of misdeeds that have been discovered in the past few months, or to what degree such misdeeds in other countries. In any event, the institutional investor /asset management sector is structured in such a way that a wide range of agency problems must be addressed. At the very least, one can make a credible case that institutional investors and asset managers bear some share of the responsibility for the excesses of the bubble that burst in 2000. The institutional investor / asset management industry represent final investors more closely than any other intermediary and manage large portfolios of assets as their agents in the capital market. Arguably, even if the corporate sector was responsible for producing deceptive information and the investment banking community for marketing practices that slanted research to assist the corporate sector in marketing, it was ultimately the responsibility of institutions and asset mangers to set the appropriate tone by demanding higher standards on the part of corporate management and the investment bankers.

Admittedly, there is some internal conflict in the task of an asset manager. Thus, while it may be incumbent on investors collectively to be demanding about the quality of information supplied to investors, their main immediate objective is to maximise the value of their portfolio. There may be incentives for the investment managers to be complicit when management produces information that helps to increase share prices, even if this requires aggressive accounting.

Professional fund managers tend to compete and to measure performance versus benchmark indices. They tend to be compensated for performance versus the benchmark and versus peers in the industry. Many analysts argue that industry practice tends to encourage portfolio managers within a given asset class to cluster very closely around the benchmark. To some degree clustering around the benchmark is understandable since the final investor has engaged the asset manager to execute a given strategy. The most effective means of demonstrating that the strategy has in fact been executed is to remain close to the benchmark. At the same time, if the asset manager merely tracks a benchmark index the investor may actually be purchasing an index fund while paying fees that are appropriate for an actively managed fund.

Those involved in asset management will often be part of a larger group that engages in other financial activities such as commercial banking or investment banking. Owners and senior managers of large financial conglomerates have decided to engage in diverse financial activities since they perceive opportunities for synergies among various activities. For example, bank branch networks and customer bases can be used to market insurance and investment products. At the same time, the linkages among various parts of financial conglomerates raises the possibility of conflicts of interest and thus requires firewalls in which various parts of the organisation are segregated and various safeguards are put in place to minimise abuse of inside information or excessively close linkage between remuneration of distinct entities in the organisation.

Although institutional investors represent the final owners of capital several organisational layers often stand between the final investor or beneficiary and the asset manager. In a typical pension fund will have trustees, who will employ consultants who assist in developing an appropriate investment strategy and engage asset managers to execute their investment strategy. In the case of CIS, OECD countries have a variety of legal and governance structures. For example in the United States, laws and regulations require organisation of each mutual fund as a separate investment company with its own board of directors who have the specific duty to act in the interests of investors in the fund. In most European countries, less elaborate structures are found and internal “firewalls” are considered sufficient to adjudicate conflicts of interest. In these systems, it is generally thought sufficient that investors should be fully informed about portfolios, performance fees, and investment policies and those investors retain the ability to liquidate the CIS at fair and transparent prices. Even though there is no consensus on optimal governance regimes. For CIS there is wide consensus on good practice in the operation of CIS. Internationally accepted the principles for the equitable operation of CIS, concerning issues such as valuation, liquidity disclosure and the role of the depository. These global standards are mainly codified in a series of principles elaborated through IOSCO. The EU has also developed accepted standards which allow those CIS meeting the standards to be marketed on a pan European basis.

Institutional Investors and Risk Transfer

Institutional investors are also of growing concern for public policy owing to their evolving role in assuming risk in the financial system. The present downturn occurs after a long period during which capital markets have been displacing banks in financial intermediation, with the full implications of this shift only now becoming clear. Previously, the public entrusted most of its saving to banks. Banks in turn were subject to official supervision, which limited banks’ risk-taking, and were usually protected by official deposit insurance. The fact that banks held most financial risk on their own balance sheets as well as the official “safety net” attenuated the impact of financial shocks on the general public. Banks’ credit problems typically elicited wide concern only when an institution risked insolvency that endangered systemic stability or required the use of public funds.

As financial intermediation moves from bank balance sheets to the portfolios of institutional investors, risk has also been reallocated. This partly reflects the relative growth in asset, but it also reflects other trends in financial services. Due to the strains on banking systems in the past two decades, banks

have been under great pressure to improve their risk management systems. They have thus become rather adept at measuring and identifying risk and have also taken part in the development of a number of risk transfer products. Part of the process of reallocating risk has resulted in a significant migration of risk to the institutional investor sector.

The build-up of institutional assets occurred when deregulation was spurring stiff competition among institutions for market share. In this context it is worth making the distinction between those institutional investors that typically maintain risks on their own balance sheets, mainly life insurance companies that accept long term commitments to policy holders and defined benefit (DB) pension plans which have long term fixed pension liabilities. Both of these investors must finance their liabilities through their own investment portfolios and both face asset/liability mismatches. Life insurance companies aggressively expanded business in investment type products, including many with guaranteed returns. To some degree risk management considerations were subordinated to market share, as aggressive pricing was used to attract funds while assuming that the returns would be adequate to meet commitments. In the case of DB plans, many companies allowed potential funding gaps to emerge by making relatively optimistic assumptions concerning future returns on pension fund assets. This may partly reflect the objective of showing maximum possible gains in earnings to please the investment community.

For both categories of institutions, a well conceived policy of risk management during the period of booming markets might have allowed them to benefit from high yields while diminishing risk in future downturns. Instead, there are major funding gaps in the DB pension sectors of most countries in which such plans are common and the future funding gaps could become a major factor undermining equity markets in the future. In the environment of falling stock markets and declining bond, many insurance companies have experienced strains on profitability and in many cases may not be able to meet supervisory solvency requirements. It can be argued that since risk has shifted to institutions of this kind they now represent a greater source of systemic risk than in the past.

Other institutional investment products such as defined contribution (DC) pensions, variable annuities and CIS typically pass investment risk on to investors. These products have also proven very popular over the past two decades, as the public has been able to participate in the rising bond and equity markets during the period. In current conditions, however, the public is more directly than ever to weak markets. Thus the linkage between the performance of capital markets and personal welfare is tighter than ever before. It will be an important challenge for institutional investor sectors to maintain the trust of the public and of legislators in the present difficult environment.

There is a rather broad consensus that the extremely high returns of capital markets that characterised the past two decades cannot be repeated in the future. Much of the gains were due to the 1980-2000 disinflation and structural reforms in OECD countries. At this time the OECD economies face difficult growth prospects. Either further decreases in the rate of price rises to actual deflation, or alternatively a resumption of inflation would engender new problems. On the side of equity, some of the impressive gains of the past 20 years were due to the removal of imperfections in the corporate sector, deregulation and the modernisation of equity markets in countries where they were largely underdeveloped. Even under the best of assumptions, however, equity valuations were driven to unsustainable levels in the bubble of the late 1990s. Optimistic observers believe that markets will stabilise and resume growth, at a rate considerably below those achieved in the 1990s. Pessimistically, OECD countries face a prolonged bear market. In either case, the capital market is likely to be less favourable in coming years than in the past. This will present a major challenge for institutional investors to keep the confidence of the public.

Institutional Investors and Governance Rights

One issue that has come to the fore since 2000 involves the use by institutional investors of their ownership rights in the corporate sector of OECD countries. As mentioned previously institutional investors by raising their exposure to equities have become major owners of major corporate entities. Thus, the question arises of how these rights should be exercised. There is some reason to think that the way in which institutions exercise their rights may have contributed to the speculative pre-2000 environment. At the very least it is clear that the collective exercise of ownership rights by investors did not prevent the corporate sector from engaging in the deceptive practices and the misalignments of interest that are now becoming obvious.

It is somewhat fortuitous that institutional investors have become major corporate owners in the first place. These institutions are specialised in managing portfolios and in assessing the value of securities. Their basic instinct is to react to corporate performance by adjusting their portfolios (i.e. buying or selling). Indeed, the investor community as a whole must react to changing corporate performance by purchases and sales of equities, and it is clearly in the interest of all market participants that a significant share of the institutional investor community has an active portfolio management stance, inasmuch as the management of companies is disciplined in large part by changes in the share price. There is no evidence that most fund investors or final beneficiaries of institutional investment products have any interest in how the proxy votes are cast or ownership rights otherwise exercised. (The exception is for social and ethnically responsible funds. In case where social or ethical screening is part of the investment style of the institution, as publicly disclosed, a process is established whereby companies are subjected to separate screening and where other ownership rights are exercised in keeping with the fund's policy.)

At the same time, large ownership presents institutional investors with a dilemma. If the institutional owners of the corporate sector do not use their ownership rights to monitor the companies, the company will have few restraints other than the share price. In a few cases, mainly private DB pensions in the US, voting of proxies is mandatory. Most other institutions are free to cast their votes or not and to formulate relevant policies. In some countries, most CIS have formulated policies and regularly cast proxy votes. In many cases, where the equity portfolio is managed by an outside asset party, the institution delegates voting rights to the portfolio manager. Some have argued that industry associations can be helpful in setting norms of conduct for the corporate sector and in communicating the views of the industry. Again the portfolio manager is mainly focused on the performance of the portfolio, rather than on exercising governance rights. Proxy voting takes place in a highly centralised manner. In the United States, for example, votes are usually cast by the parent company of the fund manager, rather than by the individual portfolio manager. The process of casting proxy votes thus takes place outside the framework for fund governance, including independent directors, that is established to assure accountability to shareholders.

In addition to simply voting, some institutions have chosen other means of seeking to influence corporate management. These various techniques frequently described as "investor activism" includes attendance at shareholder meetings and formulation of shareholder resolutions. Dialogue with management, use of the media to highlight shortcoming of management initiation of lawsuits. Additionally, such activists frequently join in investor networks to share information and coordinate action. In the United States activist investors are often public sector or trade union pension plans. There is considerable suspicion among purely private institutions of investor activism. Many private fund managers argue that there is little evidence that activism produces tangible results for investor. Many of the activists are seen as excessively politicised for purely private entities.

Even if one were to agree that some degree or more active use of ownership rights might be beneficial to investors as a group, the mechanism whereby this could be accomplished is not clear. While it might be useful for all investors to issue shareholder regulations or to initiate lawsuits in some cases, the motivation of each institution, which only owns a small share of the company's equity would be small. It is not always

plain that group of institutions would be able to agree on appropriate activity. If active monitoring is in some sense a “public good,” investors as a group may have to find means of acting in concert.

Looking Forward: A Balanced Approach to Reform

In restoring confidence is a challenge to find the right blend of measures by the private sector and the public sector. On the one hand, the public which has seen many expectations built up over two decades shattered by the post 2000 bursting of the bubble. This has raised pressures on policy makers to take some actions. In such circumstances there is the danger of hasty action that will build rigidity into the system. Additionally, there is a problem that in view of the highly internationalised markets of the present, actions taken by any one country may have unforeseen consequences in other jurisdictions. Thus many of the reforms included in the Sarbanes Oxley law have had unforeseen consequences in foreign jurisdictions and US officials are seeking to arrive at applications of US law that take into account the specificities of other systems.

Initiatives are being taken by the authorities, by individual firms and by industry associations and SROs. If reforms are well conceived they will emerge from a process of consultation between the public and private sectors and among countries. Rather than seeking to punish past transgressions in cases where flagrant violations of fiduciary responsibility are uncovered, they will be aimed at identifying areas where lines of accountability were vague and where incentives became misaligned. and will be aimed at building a more resilient system where incentives to act in shareholder interest, to disclose fully and accurately and to monitor corporate performance were stronger than in the past.

Changes are visible in mitigating some of the conflicts of interest that have been found in investment banking. Major regulatory initiative have been launched in key market such as the United States and the United Kingdom that will require stronger internal controls to separate investment banking and research as well as to set rules for the participation in new issues business. Actions on the official side are being reinforced by individual investment houses which are strengthening their internal institutional and compensation policies in order to remove the distorted incentive that contributed to the bubble.

The institutional investor side has thus far played a relatively small role in the process of overhauling the financial market. This partly reflects the fact that this sector has been less touched by outright abuses that have been found in the corporate side and in the investment banking side. Additionally, among institutional investors only CIS are directly regulated by the authorities responsible for securities market oversight. The others (insurance and pensions) are subject to regulation by other bodies. Nevertheless, there have been some initiatives. In the United States, the SEC recently ruled that mutual funds must disclose how they vote the proxies on companies in their portfolios. As wrongdoings in the US mutual fund industry have been exposed in recent months, the authorities in the United States have begun to accelerate actions and other regulators are beginning investigations to see the extent of similar abuses in their own jurisdictions. It is not clear whether similar abuses will eventually be uncovered among other categories of institutional investors.

Overall it is important for the institutional investor, who represents the ultimate owners of capital most directly to be actively involved in the process of reform, by communicating what improvements they believe are necessary to on the corporate side and on the “sell side” of the capital market. In addition, it is clearly necessary for the institutions to consider seriously whether their own governance structures and the ways in which they exercise their ownership rights in companies need to be changed.