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Shareholder Activism

Can it be an Effective Governance Mechanism?

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This paper sets out to examine whether shareholder activism can be an effective governance mechanism, i.e. if it can increase firm performance to the benefit of shareholders. We have based our study on examining and interpreting the results from previous research of the subject. Initially, we describe the theoretical constraints facing shareholder activism. Agency problems between management and shareholders introduce the need for shareholder monitoring. The incentives to monitor are limited by the free-rider problem, legislation, market liquidity and activist bargaining power. One central insight is that the cost of monitoring must be offset by the expected gains from engaging. We continue in detailing the different options commonly used by activists to influence target firms, as well as the activists themselves. Finally we examine the extent and efficiency of shareholder activism. We conclude that the amount of activism has increased during the last few years. A majority of the studies could, however, not find a link between monitoring and an increase in firm performance. Although this calls the efficiency of shareholder activism into question, the success of hedge fund activism and the fact that it circumvents several of the theoretical constraints leads us to a slightly different conclusion. Even though shareholder activists are currently unable to increase firm performance, we believe that careful design and sound legislation can potentially enable institutional investors to become effective governance mechanisms.

Keywords: Shareholder activism, Intuitional investors, Activist hedge funds

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1. Introduction

1.1 Background and relevance

Much has been written concerning shareholder activism and corporate governance during the past years; both alone and how they affect and work together. Shareholder activism is characterized by buying shares in companies in order to put pressure on the board or management of the company. Done efficiently, it is a comparatively inexpensive way of gaining influence and therefore being able to reconstruct companies both from a financial and an economical perspective. This is in comparison with ordinary private equity buy-outs where the firm normally buys the entire corporation. Corporate governance examines the way companies are directed, administrated and controlled through different sets of processes, traditions, policies and laws.

Corporate governance takes many different forms but one central and important concern is to guarantee the accountability of the individuals in an organization by minimizing the principal-agent problem. Another aspect of corporate governance is management's impact on economic efficiency, whether or not strong shareholder activism can create an effective governance mechanism in order to create better functioning companies. Through time, shareholder activists have used many different approaches to pressure corporate boards and managers to improve firm value. Traditionally, activists have included individuals, mutual funds, and pension funds. In recent years hedge funds have come to play an increasingly important role. There is much disagreement on the topic whether shareholder activism can create true improvements in the value, earnings, and governance structure of target firms.

Some studies find that shareholder activism can produce rapid change in target firms' corporate structure but that it has an insignificant effect on share price and earnings. Other studies claim that they can see short-term positive reactions, but in the long-run, there is little proof of improvements regarding the stock and value performance. Some investigations have been done concerning the valuation consequences of industry rivals to firms targeted by hedge funds and private equity investors. Current studies argue that both types of investor differ from the other block holders due to their strong motivation and capacity to actively engage and monitor management. By changing target firms` objective functions toward more of a shareholder value orientation, new institutional investors improve firm operating performance. Another view is that the announcement itself of change in ownership structure generates statistically significant positive intra-industry effects which are also positively related to a change in profitability. The rivals of shareholder activist funds experience statistically significant losses after the announcement, which can be explained by the negative competitive effects. Some take the argument even further and claim that shareholder activism is more likely to occur in large firms that appear a lot in the media. Not with the purpose of achieving better performance, but for publicity's sake.

There is little doubt that shareholder activism has increased in scale and now plays an important role in shaping the corporate governance of companies. This has lead to new problems and complexities. Shareholder activism is a mix of authority, diplomacy and sometimes even aggressiveness in the interest of shareholder value. Due to the fact of the increased growth of hedge funds and hedge fund activism, there is now a larger diffusion of shareholder interest. The consequences of this have created unavoidably public interventions with diffused effects. Some argue that legal rules intended to protect minority shareholders have the unplanned effect of deterring institutional shareholders from owning stakes substantial enough to influence corporate decision-making. Yet it is important to remember that there are many shareholders that have large ownership shares and control over companies but still have a lack of activity, for example certain large pension funds and labor unions.

1.2 Purpose of this paper

Shareholder activism and governance structure are two subjects with many different approaches of examination. The purpose of this thesis is to look at the existing literature and assess whether shareholder activism can create an effective governance mechanism. But before we can do this we have to understand what an effective governance mechanism is. No magic formula exists for the perfect governance structure. Every company has its specific needs and idiosyncrasies, depending on country, culture, history, branch, people and so on. An effective governance structure should provide a well-functioning platform in order for a company to perform as efficiently as possible. The firm's goals should be clearly defined and the way the company is directed should be managed in the interest of the shareholders. In addition, a control process should be developed so that the employees feel responsibility and motivation. Traditionally this has been handled within the company from the board or management. But what we want to appraise is whether outside participation like shareholder activism can generate value and in fact create an improved governance mechanism in order for firms to perform better from a financial and economic perspective. Our focus is to look at shareholder activists that have taken big stakes in companies, no matter of origin, with the purpose of achieving a better performance through changes in the spectrum of corporate governance. We want to find out if shareholder activists can create changes in firm's governance structure and determine whether these changes are effective in adding value to shareholders.

1.3 Outline

The outline of the thesis is structured as follows. We begin with a short section detailing our methodology. Thereafter we continue with a section examining the theoretical framework surrounding our subject. Here we will discuss the different theories within corporate governance that play a large role in providing an understanding of shareholder activism. Especially important are the problems facing efficient governance, agency costs and free riding. Here we will also discuss the two central concepts of "Voice" and "Exit". The analysis that follows is divided into two sections. The first one investigates whether shareholder activists try to change the governance mechanisms of firms. In order to respond to this question a narrow study is done with regards to different institutional investors. Focus is put on differences between countries and regulatory constraints concerning shareholder activism, like powerful boards and shareholder proposal restrictions. Moreover an assessment of rules with reference to different financial intermediaries is carried out. The aim of the first part is to give an understanding of shareholder activists' behavior and conditions. What are their possibilities to influence firms and how do theoretical and regulatory constraints affect their incentives to engage and monitor? The second section assesses whether shareholder activism can work as an effective governance mechanism. First of all we review the relationship between activism and performance. Then a detailed consideration is taken with regards to different types of shareholder activism and their diverse potential to work as an effective mechanism in the spectrum of governance resolutions. Finally, we try to answer the questions stated in the thesis with a concluding remark. Here we also detail further research that can be made as well as a critical evaluation of our work. Due to the many economic concepts discussed in this thesis, we include a list of definitions at the very end.

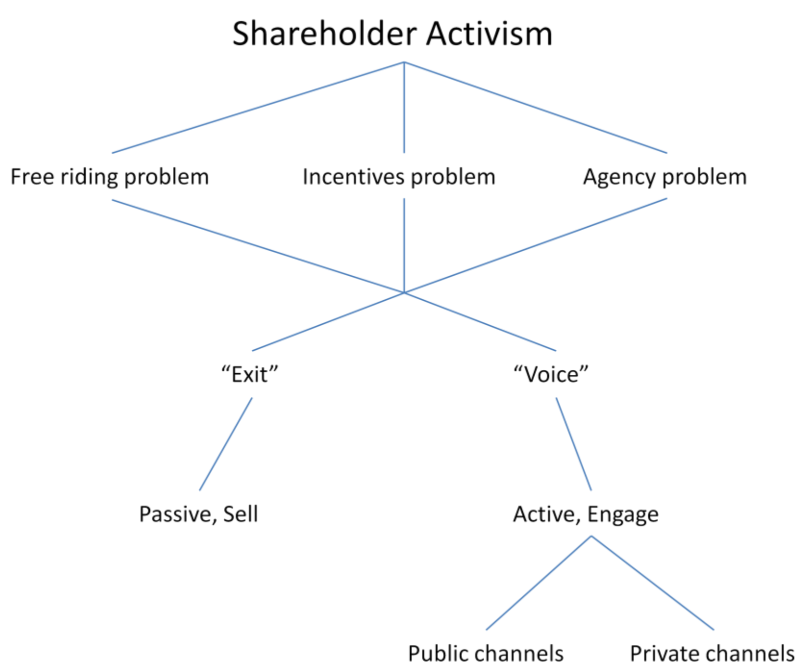
2. Methodology

The aim of this thesis is to give the reader a broad summary of the subject as well as analyzing its implications. In order to investigate its implications, we must first determine which method we should use. The choice is between a qualitative and quantitative study. The two systems have common objectives, which mean that both are focused on providing a clearer understanding of the studied question. The difference between qualitative and quantitative method lies in the manner in which the collection, processing and interpretation of the empirical material can be made.

In order to fulfill the purpose outlined in part 1.2 we have chosen to do a qualitative study. The reason for our decision is that we want to present the existing literature and focus on the different views and disagreements between economists. We want to assess the literature and review the differences and try to give objective reasons for these discrepancies. The reader will be introduced to the subject of shareholder activism and corporate governance through the theory section. This part is aimed at describing the environment in which activists operate and the theoretical constraints in order to function as an effective governance mechanism. Further on, the analysis will relate these limitations and environmental conditions to real world aspects, in what form they take and how shareholder activists react to them. In the final part of the analysis, we will evaluate whether shareholder activists can work as an effective governance mechanism. We will focus our research on papers using a control group in order to evaluate the results. This is important because the measures applied by a study to find a control group must be as sophisticated as the measures that institutional investors use to pick their targets. Otherwise the study could find a faulty link between activism and governance events (Black, 1998). By doing a qualitative study, the results can potentially face a lack of objectivity. It is also hard to defend the results. In order to overcome these problems we will try to highlight many different research papers and avoid drawing strong conclusions early on in the thesis. Additionally we want to emphasize that much of the existing literature concerning this subject is based on American studies. For this reason it is sometimes difficult to relate to other countries. We will try to be country specific throughout the writing process and precise on which country we are referring to. Still it is important to mention that the phenomenon of shareholder activism was born in the U.S and has for that reason reflected and inspired the performance in other countries.

3. Theoretical Framework

Shareholders of firms have the possibility to either engage management or to take a passive role. As shareholders are increasing their stakes in companies, their relative power to influence follows to the same extent. Institutional investors today have the capital needed to hold large positions in companies and should therefore be able to exert influence. Still, many investors prefer to remain passive. The choice of whether to engage, called "Voice" or sell off holdings, "Exit" is a central decision. But how can theory explain why big institutional investors, with their large positions and the capability to exert influence on firms, still in some situations choose the "Exit" option? The assessment of "Voice" and "Exit" concerns the agency conflicts within the targeted firm, free-riding and exterior incentive problems (all defined below). If investors consider that these problems mitigate their possibility to enhance shareholder value they will "Exit" their positions as a rational choice. But if shareholders believe that they can overcome these difficulties, "Voice" is to be preferred which can take place through public and private channels. We will present the meaning of these different problems, the motives behind them and how they can be moderated. Further, we will present different forms of "Voice" and how they relate to public and private channels. The analysis will then demonstrate how these theoretical constraints work in reality. This is done in order to create a full understanding of diverse shareholder behavior and in the end as a way to conclude whether shareholder activism can work as an effective governance mechanism.



3.1 Shareholder activism

Shareholder activism can be understood by analyzing the intensity of monitoring by traditionally passive institutional investors. The concept can be divided into two phases: an investigative phase which seeks to ascertain whether the target firm is maximizing shareholder value and an active phase that tries to change firms that fail to do so. The range of actions available to shareholder activists can be divided into two groups, “Voice” and “Exit”. We will include actively threatening with “Exit” without actually selling the shares in the “Voice” strategy. “Exit” refers to selling the shares after having taken a passive role in the company, sometimes also called the “Wall Street Walk”. Active security selection could be considered as shareholder activism`s polar opposite. Here, focus lies on stock picking and the selection process and not on involving oneself in trying to influence the organizational control structure of the firm. The growing conflict of interest between managers and shareholders has resulted in the increased importance of shareholder activism (Gillan and Starks, 1998). The main emphasis of activist shareholders has been to focus on the poorly performing firms and to pressure the management for improved performance, thus enhancing shareholder value. Shareholder activism is present mainly through large financial institutions such as investment companies, hedge funds, insurance companies, mutual funds, and pension funds, rather than individuals (Black, 1998). These investors have increased their holding during the period from the 1980’s and forward (Karpoff, 2001). The two most common forms of activism are presenting, or threatening to present, shareholder proposals during the annual shareholder meeting and demanding the replacement of members of the management or board (jawboning) in order to achieve a change in representation (Black, 1998). “Voice” activism can assume a wide range of forms, depending on both investor and target. One study identifies the following (Hedlund et al, 1998):

- **Participation at the annual general meeting:** A central part of shareholder activism is the use of shareholder proposals. At the annual general meetings the activists have the prospects to de-stagger boards, demanding a change in management, separate the position of chairman of the board and CEO and try to form a nominating or compensation group of the board composed completely of independent directors by using corporate voting rights.
- **Representation in the company's board:** The board of directors is a core component of a firm’s decision making process. A member of the board gives the ability to influence and monitor the firm’s actions.
- **Direct contact with the company`s management:** Through quiet diplomacy and pressuring the board from inside, like letter writing and direct engagement with management and the board. This is the process of using long-term relationship building and trying to achieve changes that are in

line with wealth maximizing goals, rather than outside pressure at annual general meetings. This creates room for more discussion, specific strategies and space for dialogue. In addition it does not damage firm value by making its problems public.

- **Take-over attempts:** Probably the most drastic action. If shareholder activists are unsatisfied with the operating or governing capability of management or the board and experience difficulties in influencing the firm, they can propose to buy it. Even though they rarely follow through with the takeover attempt, the threat itself works as a mechanism to gain influence and get the presented proposals accepted. Naturally not all institutions can perform this option. We will examine this further in the analysis.
- **Contacts with other shareholders:** Shareholder activists often look for the support of other institutional investors and from time to time conduct press campaigns in order to increase pressure on the management and boards of directors.

"Exit" behavior on the other hand is characterized by taking a passive role and leaving the company because of dissatisfaction with the management. This may be due to limited ability to influence the firm and the overall assessment that the free-riding and incentive problems create no room or value for engagement.

The last thirty years have shown an increase in both the amount of shareholder proposals received concerning corporate governance issues as well as private communications between institutional investors and their target firms (Karpoff, 2001). It is important to note that although economists generally agree on the increase in shareholder activism, there is still much debate on how much it actually affects firm's performance.

3.2 Corporate governance

Corporate governance has incorporated shareholder activism as an important principle. Several recent legal and regulatory changes have made it easier for shareholders to engage in activist behavior. These changes are important from the perspective of shareholders, because an effective legal system that protects their ownership rights is a prerequisite for efficient corporate governance (Daily et al, 2003). Major corporate scandals like Enron, WorldCom, and Scandia have caused a critical view of the concept of corporate governance. The conflict in interest between managers and shareholders, the classic agency problem, is one of the driving forces behind these incidents. While managers have a fiduciary duty to act in the interest of shareholders, they sometimes seek to maximize their own benefits instead. This creates a need for shareholders to monitor firms' management. We will use Daily et al's definition of corporate governance that focuses on the exploitation and use of organizational resources as well as the resolution of conflicts between parties within the corporation. Traditional corporate governance theory has focused more on protecting shareholders and controlling executive self-interest (Daily et al, 2003). In order to placate shareholders, internal and external corporate governance mechanisms are implemented to keep management's interests in line with those of the shareholder's. Examples of internal mechanisms are effectively structured board, incentives schemes, and intense ownership holdings that encourage monitoring of executives. The market for corporate control works as an external mechanism that is commonly triggered once internal mechanisms for scheming management opportunism have failed.

3.3 Ownership vs. Control

3.3.1 Interior agency problem

In the 1930s, two authors attracted attention for their theoretical contribution. Berle and Means argued that the degree of ownership concentration was central to the conflict of interest. In addition they argued that over time the separation of ownership and control leads to a dominant role for management. During the early 1900s the ownership structure of firms changed as a consequence of increasing numbers of different shareholders. The new structure resulted in the ownership concentration decreasing with a resulting separation of ownership and control. According to the theory, the problem occurs because people tend to act in self interest and to maximize their own value. Agent problems in corporate governance are due to management prioritizing its own benefit rather than shareholder value. One potential resolution to mitigate agent problems is shareholders monitoring the firm's management. Our analysis will show that even though shareholder activists have the theoretical capability to monitor firms, the possibility to influence and implement changes of governance mechanisms are hindered by staggered boards, regulations and shareholder proposal restrictions. In the end this affects the incentives to engage in costly activism. Moreover, while monitoring may cut agency problems and improve firm value, this exertion is not without cost and the benefits from monitoring are enjoyed by all shareholders which give rise to another problem, namely free-riding (Clifford, 2007).

3.3.2 Free-riding problem

If management interest aligns with shareholders and the firm is utilizing wealth maximizing strategies there is no need for outside monitoring. If this is not the case, a problem arises when one shareholder applies effort in order to improve the firm value through activism. An activist shareholder must be compensated appropriately in order to employ expensive efforts to monitor the firm's management (Clifford, 2007). When activists take on monitoring activities, this can potentially increase firm value that benefits all shareholders, although paid for just by the sole activist. This naturally discourages small activists as their share of the reward will not match the cost of obtaining it. Large shareholders, however, may receive a sufficiently large share of the reward to offset the cost of activism. For that reason, large ownership shares can work as a potential solution to mitigate free-riding of other shareholders and increase the incentives for shareholder activists to engage in monitoring (Maug, 1998). Another technique to help solve free-riding is cooperation between actors. Consolidating activist efforts in coalitions could therefore also help solve the problem.

3.3.3 Exterior agency problem

The institutional investors who usually act as shareholder activists represent countless individual shareholders and enormous amounts of capital. Even though their stakes might not exceed a few percent, the absolute value of these holdings is substantial and certainly creates incentives to monitor and improve shareholder value. On the other hand, the managers heading these funds have motives of their own. Their performance is usually compared to that of their competitors, making relative rather than absolute performance important. They will therefore place larger focus on beating competitors and benchmarks rather than increasing absolute shareholder value (Hendry et al, 2004).

3.4 Market liquidity

3.4.1 Incentives to earn money with regards to free-riding

There is an interesting paradox inherent in the theory of liquid markets. Traditional theory has focused on how highly liquid stock markets diminish large shareholder`s incentives to monitor as it allows them to "Exit" more easily. However, liquid markets also make it less costly to hold large ownership positions and easier to buy additional shares which allows for large shareholders who can exert influence (Maug, 1998). One way of testing which effect is strongest is to look at the liquidity of markets compared to the levels of activism. The fact that public markets today are more liquid and efficient than ever and "Voice" activism is increasing supports the notion that liquid markets actually do not impair monitoring (Maug, 1998).

As discussed previously, large ownership shares can help mitigate the free-riding problem and therefore increase the incentives to monitor. Maug (1998) puts forward an explanation that is based on the profits made by large shareholders that engage in monitoring. If large enough to engage, monitoring awards the activist fund with private information which it can use to conduct profitable trades with other non-informed investors. It also profits from the fact that its initial ownership share was sold at a discount during the initial purchasing offer (IPO). These two sources of profit help explain the incentives of monitoring. According to the model, investors will not assume large initial ownership stakes as they would then be forced to engage in costly monitoring. Instead they increase their level of monitoring and ownership when there is an opportunity to profit on private information, i.e. when markets are liquid. If markets are illiquid, investors will only maintain small shares. The model therefore suggests that the market liquidity is a driving factor in explaining the extent of shareholder activism.

3.5 Exit vs. Voice

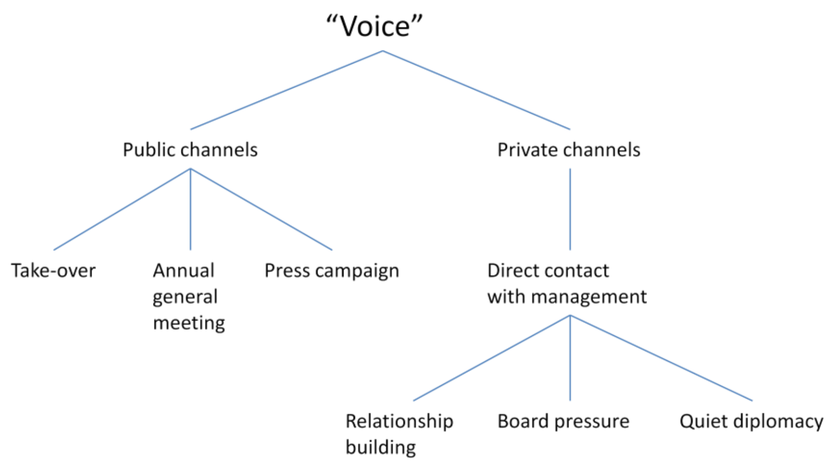
In order to make a rational choice between “Exit” or “Voice” behavior considerations should be taken to the agency conflicts within the targeted firms, and the possibilities to exert influence with regards to staggered boards, legislative constraints and restrictions on shareholder proposals. This, in combination with the apparent free-rider and exterior incentive problems and the opportunities to mitigate them, like the accessibility to liquid markets, should form the basis upon which the decision should be made. To summarize, the choice between the strategies “Exit” or “Voice” depends on a number of factors. Primarily it comes down to three questions:

1. Do we need to influence our target?
2. Can we influence our target?
3. Does the expected gain exceed the costs of influencing our target?

A rational investor who answers “yes” to all three questions should engage using “Voice”. If questions 2. and 3. are answered with “no”, a rational investor should “Exit”.

3.6 Public vs. Private channels

We have now discussed two mechanisms of activism, “Voice” and “Exit”. Sometimes, shareholder activists use a combination of the two. An important aspect of “Voice” is to attain respect and credibility towards the board of directors in order to pull off the presented proposals; usually with some sort of pressure involved. This pressure through which “Voice” takes form can occur through both public and private channels. Publicly, institutional investors try to gain support from other shareholders in order to vote against the board of directors. Privately they engage management in discussions about how to improve firm performance (Opler and Sokobin, 1997).



3.6.1 Public channels

Public channels provide an added pressure to management persuasion. Threats of hostile takeovers were believed more effective prod for change in poorly performing firms than monitoring by independent directors or jawboning by institutional investors. By taking dissatisfaction to the press, presenting proposals at general shareholder meetings or by threatening with take-over attempts, activists thought that the outside pressure would make it more difficult for firms to reject the proposals. Partly due to the legislation, not many activist proposals gained success (Del Guercio and Hawkins, 1997).

The proposals were almost always advisory in nature. Even with the majority vote, management was not complied to follow the proposals. Moreover, the staggered boards could effectively hinder a take-over attempt and made it very difficult to gain influence. After large institutional investors entered the market, this quickly changed. Now shareholder proposals started to gain support although management opposed them (Del Guercio and Hawkins, 1997).

This led to further growth in the area. Restrictions in the regulations on disclosure of communications between shareholders were relaxed, which made shareholder activism notably more attractive as it decreased both the expenses and legal problems for the shareholders involved (Del Guercio and Hawkins, 1997). This was followed by the new era of privately used channels. This was especially notable in the amount of times the board agreed to meet with activists demanding meetings. On top of that, reforms were regularly made with no formal proposal practice.

3.6.2 Private channels

Some evidence suggests that the current era of activism has moved more toward the use of private channels, characterized by relationship building rather than tender offer, by board's pressure instead of financial pressure and by quiet negotiations as opposed to highly exposed takeovers (Becht et al, 2006). This was a result of the inefficiency of the previous public actions and the new regulatory changes which had opened up the potential of new ways of monitoring. Activists nowadays tend to engage in meetings with the board, frequently looking for support from other large investors, sometimes organizing press campaigns, but seldom believe in resolutions at shareholder meetings. They seek corporate reform, changes in the compositions of the boards, restrictions on firm policies and on occasion call for changes in financial policy such as dividend allocations. (Becht et al, 2006).

4. Analysis

The analysis is divided into two sections. The first one investigates if shareholder activists engage in changing governance mechanisms of firms, how these engagements differ between different institutions, and which activists lack the ability to monitor. The second section evaluates the effectiveness of these actions and assesses whether shareholder activism actually works as an effective governance mechanism.

<u>Part: 1</u> Do activists engage in changing governance mechanisms of firms?

By the 1980s, public pension funds in the U.S had invested $44 billion, constituting around 4 per cent of the American stock exchange. 10 years later, this figure had increased to $290 billion, accounting for around 10% of the stock capitalization. This remarkable trend was coupled with an increase in monitoring activities (Wahal, 1996). Taken as a whole, the last 15 years have revealed a shift from non-interventionist firms who only monitor for trading information, to activist shareholder companies who devote resources on corporate governance questions and active relationships building. Many institutions now have senior managers in charge of corporate governance actions and many of them have assembled dedicated groups of corporate governance specialists.

This development can also be seen in the increased importance of contested firms' resolutions seen both in voting figures and media coverage (Hendry et al, 2004). We can also detect a movement away from proposals associated with takeovers to those concerning governance. These shareholder proposals are a governance mechanism formed by the US Securities and Exchange Commission, SEC, under division 14 of the Securities and Exchange Act of 1934. Presented via a shareholder, proposals are short written reports requesting the management to follow a certain course of action. They first saw use in the 1940s, usually accompanying the annual report. Attached to this was often a management reply with voting recommendations. The proposals were seldom mandatory, even with a majority vote management were not compelled to abide by the proposal. Winning the vote did however send a definitive indication to management of shareholder opinion (Del Guercio and Hawkins, 1997).

After large institutional investors started entering the market, this changed quickly. Now shareholder proposals started to gain support even in the face of management opposition (Guercio and Hawkins, 1997). The 1990s brought additional growth in the area. After nearly 40 years, the SEC began to relax the boundaries in the rules on disclosure of communications between shareholders. This made shareholder activism considerably more interesting as it lowered both the expenses and legal problems of the participants. This was connected to a boost of non-public activism, a new era of private channels, operating straight with management. Looking at the Swedish stock market today, it is clear that the amount of shareholders has decreased. Compared to 2002, there are 14% less diverse shareholders today in the Swedish listed companies. In effect, Swedish households only hold 15% of the ownership of Swedish listed companies. The result is that the institutional ownership has increased at the expense of the households. For the western world, the postwar period has displayed a sharp increase in institutional owning and the trend is expected to continue during the next decade.

4.1 Shareholder activism by different institutions

Today's financial markets contain many different investors. They all have strategies for maximizing returns; some of these strategies recognize activism as an important part. Still, many of them operate under different conditions and for this reason have diverse incentives to monitor targeted firms. Institutional activists can basically pursue two different goals: economic change in order to increase value (shareholder approach), and ethical policy change in order to improve other firm aspects (stakeholder approach). The free-rider problem and the market liquidity will also affect the incentives to engage in activism. We will now present a list of the most important actors today.

4.1.1 Mutual and pension funds

Mutual funds invest in companies for the purpose of achieving maximum return. The main intention is not to take an active role in the companies, but due to the high level of assets under management, these mutual funds are often forced to engage in monitoring of the companies. Contemporary pension funds show different forms of shareholder activism. Active involvement in target firms is present, not to mention litigation against companies acting outside the interests of shareholders (Wahal, 1996). But, even though institutional investors hold large stakes in listed firms, they seldom participate in the most powerful forms of activism. Mutual and pension funds therefore rarely initiate takeovers, proxy fights, strategic voting, shareholder proposals and so on. Although these institutions own large stakes collectively, individually they are often limited to minority shares. This often makes the increase in return inadequate to pay for the monitoring. The free-rider problem is also highly applicable as competitive institutions want to free ride on the benefits at the least amount of cost. Some mutual funds are also bound by their charters not to engage in monitoring. Instead, upon deciding that management is not acting in the interest of shareholders, mutual and pension funds are more inclined to do the so-called "Wall Street Walk", i.e. sell their shares and "Exit" (Admati et al, 2005).

4.1.2 Hedge Funds

Hedge fund activism is the subject of great attention in current literature. This is due to the fact that they face less regulatory barriers and conflicts of interest than traditional investors, and can therefore take a more active role. This can be seen in the fact that their demands are often far more drastic than usual activists, varying from board restructuring to public confrontations like shareholder proposals, lawsuits, and takeover efforts (Becht et al, 2006). By examining the structure of hedge funds one finds that funds engaging in activism are more probable to have longer lockups and withdrawal notification periods than other institutional funds which make their investments less liquid. This is in line with the proposal that reduced liquidity increases the incentives for active "Voice" activism by making its alternative, "Exit", more difficult. This means that they have an incentive to pursue longer-term strategies, namely engaging in order to increase value. They are also more focused on their objective and are unburdened by the politically-motivated agendas of many pension and mutual funds (Boyson and Mooradian, 2007). As managers often invest personal assets into their funds and compensation is performance-based, the exterior agency conflict is also reduced. On top of that, as hedge funds do not face diversification constraints, they can, as a last resort, simply buy up the targeted firm and through this process obtain changes in governance mechanisms (Clifford, 2007).

4.1.3 Labor unions

Labor unions have diverted from their traditional role of passive ownership and investing in companies based on their openness to union activity. Today's labor unions have become aggressive investors, forgoing many ideological aspects in favor of maximizing return on capital. Theoretically, labor unions have a good standing position for activism due to their informational advantage. Their close ties with employees and the board grant them insight into operations and give them the ability to gain inside information. Their monitoring benefit can also increase firm value by keeping management in line and reducing agency costs. This is done through the corporate voting course to push for diverse policy transformations, from redemption of rights plans and confidential shareholding to deciding management compensation (Schwab and Randell, 1998).

4.1.4 Investment companies

The core business of investment companies is to invest in listed companies with a good potential for increasing in value, and then through active ownership help to create value and to realize it in connection with a sale. The active ownership role requires considerable influence and means that the investment horizon is long term. An active investor perspective gives a good understanding of the holding companies' activities, environment and ongoing development. Work is conducted in a structured manner within the framework of three main processes. These are the processes of investment, active ownership and exit evaluation. The last one, exit evaluation, is what differentiates many investment companies from mutual and pension funds. Before targeting a company they have a clear goal when to make an exit. The main goal is to surpass the market index through active engagement. Investment companies operate in the same mode as hedge funds, with less legal barriers compared to mutual and pension funds. They have been involved in numerous engagements during the past few years. Much of the activism aims to improve financial figures, increasing dividends and achieving representation in the board.

4.1.5 Ethical investment companies

Generally, ethical investment companies do not take an active approach to the control of companies in which they invest. More emphasis is placed on choosing the correct companies than trying to influence them afterwards (Lewis and Mackenzie, 2000). A dialogue is often maintained in which the target firms are surveyed and pushed to continue performing in line with the ethical criteria of the investment company. Active management is more common in the US even though few funds actually engage with management. One explanation for the lack of activism is that the selection process itself screens out those companies that would force the ethical funds to act. In effect, this means that the companies who perhaps are most in need of ethical guidance are unlikely to interact with, or be pressured by, the ethical funds.

So far, we can conclude that even though mutual and pension funds hold considerable positions in public firms, they still play a limited role in monitoring activities. Their problems in relation to free-riding, incentives, and legal barriers lead to “Exit” behavior rather than engagement. Hedge funds and investment companies are less constrained and can therefore to some extent overcome these problems. While ethical investment funds usually take a passive role, the labor unions can with their strong links to the employees and the board of directors gain inside information and as a result prove to be an interesting actor within the field of shareholder activism. Still it is important to remember that institutional investors do not operate under the same conditions worldwide, and their actions will vary depending on the country in which they operate. This means that we can also observe different forms of activism nationwide as well as between diverse institutions.

4.2 Shareholder activism in different countries

Bengtsson et al, 1997 have looked at Swedish institutional investors’ activity in their investment targets. He finds that shareholder activism is performed mainly through the use of informal discussions with management and between investors in coalitions. Mutual and pension funds in Sweden have a relatively low degree of activism. Some claim that this is a result of legislative ownership restrictions where these actors are limited to owning 10% of the shares, which impair their ability to exert influence. But comparing this with mutual and pension funds in the UK, we can see highly effective results with only 1-2% of total votes (Bengtsson et al, 1997). The lack of activity in Sweden can most probably be related to the incentives to monitor and the appetite to spend adequate funds on engagement and competence. In contrast, the UK is showing a new aggressive form of shareholder activism. This kind of activism is more uncommon in the rest of Europe due to its large block holdings and tradition of insider governance. Hendry et al, 2004 performed a study in which a number of senior fund managers and heads of equity from 11 of the 20 largest asset management firms in the UK were interviewed. One of them commented on the French market:

"I think you would be laughed out of the room if you tried to engage. We do vote in France, obviously, but it's interesting to see people's reactions when you actually say to an investor you might want to vote 'no'. They look at you as if to say 'which planet do you live on? You don't vote against management!' What you do, is you write a letter saying that you are not happy, but you still vote in favor of the current management, so everybody's happy because you've covered your back." (Hendry et al, 2004)

How can we explain the occurrence of these new active institutional investors in the UK? It is obvious that some aspects of the UK market must be beneficial for shareholder activism. The UK takes a middle ground between two extremes. Other European countries have firms controlled by large block holders, leaving little room for activism. The ownership structure in the US is so dispersed that the free rider problem makes profiting from activism very difficult. In the UK the market is dominated by institutional investors, which makes shareholdings more equally dispersed (Hendry et al, 2004). As voting rights are often delegated to fund managers, voting rights are also far more concentrated (Hendry et al, 2004). American corporate governance reform has been dominated by stricter legislation and compliance to stated requirements. UK reforms, in contrast, have relied more on self-regulation and the development of advisory standards (Hendry et al, 2004). This uncertainty regarding governance forced British companies to .communicate and opened up the channels where the new private channel activism is operating. With regards to legislative differences between the UK and the US, the next section will demonstrate that UK boards are far less restricted and less powerful in comparison to those in the US which creates further incentives and possibilities for shareholder activists to engage and influence.

Since American institutions are far more constrained by legal issues, such as staggered boards, shareholder proposal restrictions and difficulties in order to coordinate their efforts, far less communication occurs between management and their shareholders (Gillan and Starks, 1998). Even though some activist investors try to engage with management, the greater part of institutional investors appears content to maintain a passive role. Another quote from the Hendry et al, 2004 interviews, regarding the US described the situation like this:

"If you go to the States they don't feel that obligation to engage with companies at all. They see the investment management process as being far more 'you are making a financial bet' and they see it as they are in possession of a betting slip." (Hendry et al, 2004)

4.3 Regulatory constraints concerning shareholder activism

4.3.1 Staggered boards

The low degree of activism performed by investors in the U.S can partly be attributed to regulation regarding the structure of the board of directors. The essence of activism is the ability to influence targeted firms, but the board structure in U.S has made the boards so powerful that even large shareholders have difficulties to exert pressure. During the wide-spread hostile takeovers of the 1980's, many firms chose to implement the staggered board structure as a defensive measure (Guo et al, 2008). Since then, shareholders have realized that it reduces their influence and have usually refused to sanction the staggering of de-staggered boards. Due to the fact that boards can be staggered pre-IPO, the system is still prevalent and as of 2000 they were apparent in 60% of the firms traded on the S&P 500 (Guo et al, 2008).

Staggered boards, also called classified boards, are a system where board members are divided into different classes with different term lengths. Elections are usually performed annually but only for those board seats whose terms have run out. This means that it is impossible to replace the entire, or even a significant part, of the board at one time. There are both advantages and disadvantages with this system compared to annually elected boards. Proponents argue that it is positive for the firm to have continuity in the board of directors as this encourages long-term wealth creation. The difficulty of replacing boards also lowers the risk of hostile takeover. Critics argue that staggered boards are less accountable to shareholders and that they come to act more in the interests of managers. As one of the most effective defenses against takeovers, many of these critics argue that this system destroys shareholder value. Boards can be changed in two different ways: shareholders can engage in a proxy fight and an outside investor can purchase sufficient shares to take over the firm. Both of these are made far more difficult by staggered boards.

Shareholder activism can play an important role in pressuring firms to adopt de-staggered boards. Studies suggest that firms with staggered boards show lower firm value than those without (Bebchuk and Cohen, 2004). One explanation is the value lost from not allowing profitable takeovers to occur due to the entrenchment of management (Guo et al, 2008). Activists therefore both have the means and motive to act in order to de-stagger boards. The concept of staggered boards does not exist in the UK Their Company Law gives shareholders the non-waivable right to replace board seats even between the annual general meetings. In addition, the UK City Code forbids boards from acting against takeover bids and instead focuses on putting them to the vote as soon as possible (Guo et al, 2008). The comparative weakness of UK boards goes a long way in explaining why shareholder activism is more prevalent.

4.3.2 Shareholder proposals and coordination restrictions

Shareholder activism in the US has for a long time relied on shareholder proposals, but even these have restricted the activist's agenda. Shareholder proposals in the US on corporate governance matters are normally presented under SEC Rule 14a-8, which permits a shareholder to put forward a proposal and a 500-word supporting report, distributed by a company for its annual general meeting. Large shareholders are allowed to prepare proposals outside of this rule, but they seldom do (Gillan and Starks, 1998). The motive behind using Rule 14a-8 is allowing shareholders to avoid the expense of preparing and distributing their own statements and requesting their own proxies. It is crucial to keep the costs down of monitoring activities in order to ensure that this spending does not harmfully detract from their returns, both absolute and relative to less active competing institutional investors who can otherwise free-ride on their efforts.

The disadvantage of using Rule 14a-8 is that a shareholder must put forward a proposal six months before the shareholder meeting, and is constrained in the subjects the proposal can address. In particular, a shareholder cannot use Rule 14a-8 to propose candidates for the board of directors (Black, 1998). Another restriction that has affected American institutions is their ability to synchronize their activities due to legal obstacles. Shareholders who together owned more than 5% of a firm`s shares and attempted to act together on voting questions had to file in a Form 13D with the SEC, or otherwise risk facing a lawsuit by the firm or by other shareholders claiming fragmentary disclosure of their plans (Gillan and Starks, 1998).

Nowadays, the SEC has modified its rule and accepts large shareholder to report their positions on a simpler form 13G, instead of 13D. Before the legal change, shareholders were forbidden to talk about corporate matters with more than ten shareholders or shareholder groups lacking prior SEC approval. When this rule was adjusted, it allowed shareholders holding less than 5 percent of total shares, with no vested interest in the topic being discussed and not seeking proxy voting authority, to correspond with other shareholders. The result was significantly reduced costs for creating shareholder alliances in order to attain more support for desired changes. Therefore, large shareholders began having more direct negotiation with company`s management and less reliance on proposals (Gillan and Starks, 1998). In other words the use of private channels increased.

4.3.3 Regulations concerning shareholder activism in Sweden

We can distinguish that although shareholder activism has been around for quite some time, the laws and regulations have not developed to the extent that they allow activists effective corporate governance of firms. In Sweden, apart from the 10% ownership constraint on mutual and pension funds and the international rule of disclosure when reaching certain ownership levels, there are no laws at all concerning active ownership for institutional investors. Instead, institutional investors usually draft their own ownership policy. In contrast, US pension funds are regulated by the 1974 Employment Retirement Security Income Act (ERISA). This legislation aims at protecting employee benefit plan participants by stating information disclosure requirements, manager responsibilities, and by allowing access to federal courts. Fund managers are forced into activism through the stated obligation that they attend and vote at the general shareholder meetings. Other US institutional investors have also started using this legislation as a standard. Institutional investors in Sweden have a very negative opinion of ERISA. They state that Swedish corporate governance works well and would only be hindered by regulation. They also think that the obligation to attend all general shareholder meetings is impractical and would place an unrealistic burden on fund managers. They would be required to increase personnel costs which would lower the proceeds from the fund.

4.3.4 Regulations concerning different financial intermediaries

Compared to mutual and pension funds, hedge funds are largely unregulated in terms of activism. Their organizational features also make them interesting in view of their effects on shareholder activism. Hedge funds generally appear far more sophisticated than other institutional investors and do not fall under ERISA jurisdiction. These investors are more likely to become active as both their stakes and knowledge are greater. Unlike mutual funds, hedge funds need not diversify in order to receive preferential tax status. This means more concentrated holdings which eases the cost of monitoring. Mutual funds must maintain a much higher level of liquidity in order to allow investors to withdraw their capital. Hedge funds have longer investment horizons and impose constraints regarding withdrawals. This enables stability and the ability to hold large illiquid blocks for longer periods of time. All these factors seem to indicate that hedge funds should have an easier time engaging in activist behavior (Clifford, 2007). Moreover, hedge funds have an ultimate instrument in their magazine which increases their relative negotiating power with the firm's management or board. Specifically, if the hedge fund is unsatisfied with the operating or governing capability of management or the board, it can just basically propose to buy the firm. In other words, if the market for partial corporate control is not an adequate disciplinary mechanism, the hedge fund has the market for complete corporate control at its disposal.

Part: 2 **Can it be an effective governance mechanism?**

So far we have analyzed different shareholder activists and focused on the associated constraints in terms of creating an effective governance mechanism. We can conclude that legal barriers hinder activists in a number of ways, especially in the US Powerful boards, strict regulation concerning shareholder proposals, and free-rider problems in combination with incentive dilemmas works against shareholder activists. This is especially true within mutual and pension funds which often leads to the "Exit" option as the only and best choice. However, there are still institutional investors, including mutual and pension funds, that try to exert influence and continue to work for a better corporate governance of firms. Usually this is done through shareholder advisory committees which target the composition of the board of directors and executive's compensation systems. Below we describe how this is done and why it is important.

(1) Shareholder advisory committees
(2) Changing the composition of the board of directors and its committees
(3) Restructuring executive compensation

(1) Shareholder advisory committees in the U.S, present numerous proposals under the Rule 14a-8. Much of the proposals concern the ability to pressure the board. Two important issues are to eliminate or deteriorate a firm's poison pills and destaggering the board of directors. Other matters of concern are making shareholder voting confidential, ensuring no outside pressure is put on minorities, and the possibility to set the company up for sale and separate the position of chairman of the board and CEO. Lastly, activists often try to form a nominating or compensation group of the board composed completely of independent directors (Black, 1998).
(2) The ability to eliminate weak executives is an essential part of an efficient board of directors (Fama, 1980). By creating structurally independent boards, unburdened by management and a using a separated leadership structure, ineffective executives are easier to remove before crises occur and it is too late to avoid corporate bankruptcy (Daily et al, 2003)
(3) When Shareholder advisory committees construct pay packages for directors, they are usually focused on aligning management incentives. This is done by imposing a modest base salary, yearly bonus activated by accomplishment of financial goals and a share of profits under a "carried interest plan". In this way management gains the incentive to work in the shareholders long-term interest (Becht et al, 2003).

One study shows that 72% of target firms accepted proposals by shareholder advisory committees concerning governance structure resolutions or made adjustment adequate to justify a settlement (Smith, 1996). This proves that even though legal barriers exist in combination with free-rider and incentive problems, shareholder activists can obtain changes in the governance of firms. But are these changes an effective governance mechanism in terms of improved firm performance?

Firm market value was shown to increase if activism was expected to improve firm performance. This was also the case if activism could increase the probability of a take-over attempt. But if legislative constraints made the probability of successful activism low, no increase in shareholder value was apparent. (Becht et al, 2003).

4.4 Measurements

Shareholder activists use different instruments to achieve changes in the governance of firms. The efficiency of these instruments can be measured in different ways. For example, evaluating the proposals presented by shareholder advisory committees at annual general meetings is easily done by looking at the voting outcome. A change in the board of directors, in contrast, necessitates broader and more sophisticated measurements. Institutional investors frequently target poorly performing companies for reconstruction. But these firms are already more likely to become takeover targets or experience management change, due to their performance. It is important to use a control group of firms that were showing the same poor performance but who were not engaged by activists. During the search for these control groups it is important to ensure that the measures employed to find them are as sophisticated as to ones used by the institutional investors to choose their targets. Otherwise the study could find a find a misleading correlation between activism and governance events (Black, 1998). Stock price performance is another natural candidate to examine, but the same caveats about control groups apply. We have only looked at studies using this approach.

4.5 Relationship between activism and performance

The relation between activist efforts and firm performance is probably the most discussed subject concerning shareholder activism. Most of the disagreements between economists are based on this question. For some, activism is believed to resolve monitoring and incentive problems in companies and thus provide improved firm performance. To others, shareholder activists lack the necessary knowledge and resources and as a result are sometimes described as disturbing, opportunistic, foolish, or ineffective.

It is possible to observe different shareholder activist efforts as well as identifying how they operate. The question whether these efforts create better firm performance is much more complicated to answer. This is partly due to the fact that many studies have looked at specific funds or countries, making it hard to generalize about the effects. Finding suitable benchmarks for calculating abnormal returns is also difficult. As firm performance fluctuates daily due to a number of factors, known and unknown, discerning the effects of activism can present a daunting task (Gillan and Starks, 1998). In addition, measuring the welfare costs of shareholder activism in comparison with other governance mechanisms is complicated.

Some claim that the very presence of activists causes pressure upon management because they realize that they are being observed. In this way, activists play an important role for all shareholders of the firm. Furthermore, the argument is made that activists work for long-term value creation. Strickland et al, 1996 arrive at the conclusion that activism can produce changes in the governance structures of target firms, but that the short-term effects on firm performance are negligible. One reason why the short-term effects are insignificant is put forward by Smith, 1996. He states that although 72% of firms targeted by activists accepted the presented proposals or made adjustments adequate to justify a settlement; they usually did not do so directly. The adjustments took time, only 6% of the firms made these changes during their first year of targeting. Meitzner et al, 2008, advocate that short-term positive intra-industry effects occur upon the announcement that activists have entered a company, i.e. that its competitors experience negative effects.

The long-term relationship is even more debated. A large number of studies fail to find a relationship between performance and activism (Black, 1998) (Del Guercio, 1997) (Karpoff, 2001) (Wahal, 1996). In these studies firm performance is usually measured by abnormal stock price returns, return on assets, or return on equity. Activism is measure by institutional ownership, activist ownership, or the number of shareholder proposals submitted. Testing for the correlation between these two factors yields no significant results, neither for long-term nor short-term effects (Becht et al, 2006). Even though some activists have the skills and abilities required, this expertise is very limited as a whole (DeLong, 2000). Three fundamental reasons are blamed for the inability to link activism with short and long-term improved firm performance (Becht et al, 2006):

1. Inadequate monitoring due to free-riding
2. Legal and institutional barriers to activism
3. Incentive problems between institutional investors

Starting with the first, most of the mutual and pension funds hold stakes so minor in listed companies that they feel too small to exert any real influence. The problem comes down to internalizing the profits of activism while the benefits accumulate to all shareholders. This is one of the reasons why pension and mutual funds do not spend enough resources, in all of its forms, on monitoring (Becht et al, 2006). Del

Guercio and Hawkins, 1997, show that most institutional investors spend less than a half basis point of total assets under management per year on monitoring efforts.

As mentioned earlier, legal and institutional barriers are other elements which are hampering activist behavior, especially in the US. These barriers, especially staggered boards, confine activism to mainly public "naming and shaming" and the presentation of non-binding shareholder proposals (Becht et al, 2006). The UK, in contrast, shows a far more beneficial institutional structure for activism.

Finally, there are conflicts of interest and incentive problems between the different institutional investors (Black 1998). Apart from the exterior agency problems we have discussed earlier on, there are several problems deriving from the large scale of mutual and pension funds. Investors might hold stakes in firms where they also have a pension fund mandate. This makes them unwilling to risk their position through activism (Becht et al, 2006). Pension and union funds are also involved in the firms to a degree where conflicts of interest with the shareholders might arise (Becht et al, 2006). This conflict of interest also comes from the fact that they are often influenced by political interests.

Alternatively, the answer is much simpler. Perhaps shareholder activists are unable to aggregate sufficient pressure on boards in order to make them accept their demands. Collective action has proven effective in the UK, where activists join forces and benefit from each other's knowledge, resources, and influence (Black and Coffee, 1994). This practice is unusual in the US even though the SEC has amended rule 13D regarding correspondence between shareholders. Instead activists are prone to act by themselves.

Even though the evidence suggests that activism has little effect on firm performance, there are still studies that seek to prove the opposite. One method of doing this is by dividing the process into different parts and showing that, although certain parts do not work, the overall process creates value. One such attempt is to point out the increasing importance of private channels (Becht et al, 2006). Another is to focus on institutions, such as hedge funds, that can actually show positive performance effects. Becht et al, 2006 perform a study on the UK activist hedge fund Hermes. They found that the fund was highly successful in its monitoring efforts and that these interventions resulted in substantial shareholder gains. Becht et al, 2006 concludes that the fund significantly outperformed benchmarks and showed that abnormal returns are higher through engagement activity compared to pure stock picking.

The three-way investment criterion employed by the Hermes fund is remarkably similar to the theoretical approach we presented in section 3.5. A first evaluation is done with regards to if the company is underperforming. Second, whether it can engage successfully. Finally, the fund evaluates if this success can lead to at least a 20% increase in value. If the criteria are met, Hermes invests and begins bringing about changes in the governance structure of the firm. First, private channels are used. If the management agrees to the presented proposals the fund then surveys the implementation and awaits the market effects. If the management refuses to accept the proposals, public channels are activated in order to put pressure on the firm. The changes proposed are operational as well as financial. They include preventing acquisitions and capital expenditure as well as replacing management and board members. Financial policy is also targeted, especially matters regarding dividends. Restructuring actions are correlated with the highest abnormal returns. In conclusion, the study presents a significant link between activism and improved firm performance.

4.6 The effectiveness of different shareholder activists

There are many different types of investors on the financial markets of today. They each try to maximize return according to their outlook on the market and methods of investment. The question then becomes: which institutions are able to most effectively implement shareholder activism and demonstrate strongest linkage between activism and improved firm performance? The free rider problem tells us that it monitoring should be more unlikely in the event of many dispersed shareholders, as each will be inclined to free ride on the effort of the one activist. Activists are also more likely to become large stakeholders due to the fact that their gains from successful activism can offset the cost of monitoring and engaging (Gillan and Starks, 1998).

4.6.1 Gadflies as activists

Gadfly is a term sometimes used to describe the active individual investor. Proposals sponsored by these gadflies gain fewer votes and are related with a minor positive impact on stock prices. Shareholders take under consideration the basis of proposals presented by different shareholder activists in the voting process (Becht et al, 2006). Proposals presented by the gadfly investors on areas such as executive compensation, director ownership, and the limitation of director terms typically obtain low voting support (Becht et al, 2006). These proposals are therefore not seen by other shareholders as efficient enough in pressuring corporate management to pursue restructuring. For active individual investors to gain better voting results they should coordinate in groups in applying pressure to managers.

4.6.2 Pension funds as activists

In contrast to the gadflies stand the largest actors, the pension funds. They utilize a range of monitoring mechanisms in their activism methods. The evidence indicates that they are quite successful in changing the governance structure of targeted firms. Specifically, Gillan and Starks show that 40 per cent of the proposals presented by pension funds were implemented by the target firms. The range of the proposals varied from changing the board of directors, compensation packages to the elimination of takeover defenses (Gillan and Starks, 1998). But, even though pension funds can be classified as successful in changing the governance structure of firms, these changes still show negligible impact on the stock price and accounting measures of performance (Wahal, 1996). Smith, 1996 states that there is a noteworthy positive firm performance response for successful targeting actions by pension funds, but also a considerable harmful effect for unsuccessful proceedings. This spreads doubt on the effectiveness of pension fund activism in improving firm performance. Several studies declare that the explanation for this is that shareholder proposals are usually ineffective.

Some argue that the results are not surprising because of the agency problems within the funds themselves, the exterior agency problem detailed in section 3.3.3. Romano, 1993 argues that public pension funds are subject to pressures to take actions that are politically popular, but that harm the funds' investment performance. Murphy and Van Nuys, 1994 continue that public pension funds are run by individuals who do not have the appropriate encouragements to maximize fund value. Both studies argue that public fund managers may well use proposals only to generate publicity or enhance their reputation in order to further their careers.

4.6.3 Hedge funds as activists

Hedge funds are the only actors which can show a significant link between activism and improved firm performance (Clifford, 2007). Boyson and Mooradian, 2007 have conducted a study that shows that hedge fund activism improves the short-term stock price as well as the long-term performance of targeted firms. Brav et al, 2006 describe hedge fund activism as:

"A new form of arbitrage that generates large positive abnormal returns for both shareholders in the target companies and those in the activist hedge funds."

Unlike mutual and pension funds, hedge funds are not obligated to disclose their holdings each quarter (Boyson and Mooradian, 2007). They must only announce when they have reached a 5% ownership share which makes it easier for them to quickly enter target firms. Several studies show that this disclosure in itself is enough to raise the target firm's stock price. Between 2004 and 2005, 110 hedge funds disclosed around 370 positions in 340 firms. This was associated with an abnormal positive return of 6% over a 21 day period (Brav et al, 2006). Another study during the same period showed similar results. It recognized

102 hedge funds which made 194 disclosures in 155 different firms, achieving an abnormal return of 7.3 percent (Klein and Zur, 2006).

Looking at these results raises the theory that the organizational structure of hedge funds promotes the efficiency of activism. In comparison to mutual and pension funds, hedge funds have a structure that mitigates many of the problems we have discussed constraining shareholder activism. We discussed several of these aspects in section 4.1.2. They are all important but the one that shows the most significance is the hedge funds' ultimate weapon: the takeover. Basically, if all other efforts to influence management through partial control are expended, hedge funds have the regulatory opportunity and financial means to assume total control. Although the takeovers are seldom performed, the threat itself is enough to give the hedge fund activists a large amount of bargaining power (Clifford, 2007). Therefore, resolutions put forward by hedge funds that threaten to takeover target firms have a much higher probability of being accepted, and typically lead to higher increases in return, compared to those from other investors (Clifford, 2007).

Research also reveals that this practice is beneficial for the hedge funds themselves. Those performing aggressive activism saw returns which were 7-11% higher than those who abstained (Boyson and Mooradian, 2007). Most hedge funds, despite the apparent return, do not engage in shareholder activism. Out of the 1.5$ trillion hedge fund industry only around 50$ million is devoted to activism (Clifford, 2007). The active hedge funds must therefore fund their monitoring using their higher returns. It also implies that certain hedge funds are specializing in activism.

4.7 Experiences with other institutional investors

So far we have focused mainly on shareholder activists who act in order to change corporate governance with the purpose of increasing return on their invested capital. The last twenty years have seen a rise of new investors taking an active role for reasons other than only financial. Labor union funds spotlight the interest of employees. Ethical investment funds and interfaith responsibility investment funds promote different environmental, ideological and religious values. The interests of these alternative activists often differ from those with only value-oriented perspectives. This raises the question whether these alternative investors can be more effective in changing the corporate governance structure of firms and in the end more successful in linking these changes to performance?

4.7.1 Reasons behind alternative shareholder activism

The corporate scandals of our time have provoked a new wave of corporate ethical responsibility. Today, listed firms, both independently and through support of above mentioned institutions, work hard to show stakeholders that they are actively working with these issues. One way this is being done is by establishing and maintaining a public policy concerning ethical standards. Most listed companies have ethical codes or codes of conduct, sometimes even publishing them alongside with other financial statements. This sharing of inside information shifts the monitoring responsibility to the shareholders, and gives them the opportunity to opt out if the company acts in conflict with its stated standards. In addition, firms face a public backlash if they fail to uphold their principles, risking lawsuits, regulatory changes, and boycotts. Stating ethical standards and allowing visibility increases risk of highly public activism and therefore makes it important for firms to understand and address the concerns of its stakeholders (Korac-Kakabadse et al, 2001).

4.7.2 Their governance role

Labor unions have started to aggressively using their shareholder power in order to pressure firms to adopt corporate governance reforms. Up to now their activity has remained mostly within the tactical theatre, usually focusing solely on short-term self interest. If labor unions start to adopt more strategic activism, then possibly lasting and effective governance changes can occur. Strategic activism would involve concentrating on areas where union interests coincide with those of other investors. Since, labor unions have a good standing position for activism due to their informational advantage concerning firm operations; they can therefore prove a valuable ally for other activists. Their monitoring advantage can potentially increase firm value by keeping management in line and reducing agency costs. By demonstrating that they are willing to work for long-term shareholder growth they would be able to gain the connections and voting support of other stakeholders. Labor unions could therefore reform ineffectual corporate governance systems, especially monitoring for securities fraud and other types of corporate misconduct and this strategic transformation would change labor union's role from hostile to cooperative (Schwab and Randell, 1998).

Ethical funds generally do not engage with their target companies. They communicate, often through meetings, but their governance role is small (Lewis and Mackenzie, 2000). Generally ethical funds instead operate by using passive market signaling. This means that they only invest in companies deemed to uphold their ethical guidelines and cannot be seen as an active investor with regards to changing the governance mechanisms of firms.

5. Concluding remark

5.1 Do shareholder activists create an effective governance mechanism?

The aim of this study was to examine whether shareholder activism could be an effective governance mechanism. Theory suggests that there are several factors that influence and limit the extent of shareholder activism. Agency problems are the very reason shareholder activism is needed. As people tend to act in their own self interest, the separation of ownership and control in firms causes a conflict of interest between management and shareholders. Monitoring the firm is therefore required in order to safeguard shareholder interests, but this is constrained by the free-riding problem. Investors will not exert costly effort if they only receive a small share of the benefits. Exterior incentive conflicts, i.e. between activist fund managers and the shareholders they represent, are also potentially a factor which limits the efficiency of shareholder activism. Other factors include legislation, market liquidity, the competence within institutions, and the bargaining power of activists. The funds employed for monitoring are often insignificant in comparison to the holdings of the investor.

Despite these limitations, several studies show that shareholder activism is increasing in extent. One of the reasons for the high rate of intervention observed in American institutional investors is the fact that they are forced into activism by the ERISA legislation. Mutual and pension funds usually hold portfolios in which many different firms are included. Monitoring them all is highly impractical. They invest in companies because they believe their current value is attractive and not as a target for monitoring. But since they are forced into activism, their only possible choice is to take a passive role, the so called "Wall Street Walk", because they cannot engage in all firms included in their portfolio and spend adequate amount of funds and monitoring efforts in all of them. This is a potential reason for the lack of activity by mutual and pension funds. We believe that institutional investors can generate changes in the corporate governance of firms, but the question is whether these changes work as an effective governance mechanism.

It is far easier to study the extent of shareholder activism than its effects. Activist behavior is easily quantifiable especially due to the fact that many engagements are public. Even the private interaction between activists and their target firms has been studied and analyzed. Testing for the effectiveness of activism is much more difficult. Studies are constrained by the fact that it is impossible to know when the effects of activism will, or should, appear in firm performance. In addition, firm performance is influenced by a large number of other factors, making the isolation of activist efforts difficult.

Many of the studies we examined failed to prove a link between activist efforts and increased firm value. This leads us to believe that shareholder activism on the whole, despite growing in extent, is ineffective in increasing shareholder value. Drawing such a conclusion might however be premature. Throughout this thesis we have looked at several of the problems and limitations that constrain effective activist behavior. We have also discussed the studies that have shown successful instances of shareholder activism. Hedge funds, in particular, prove a very interesting candidate as studies show them to actually be able to increase firm performance through intervention. Perhaps the most interesting aspect of hedge fund activism is the fact that their structure mitigates many of the theoretical limitations we have discussed. This means that effective shareholder activism is far from impossible. Through careful design and sound legislation, institutional investors have the potential to become effective governance mechanisms. We therefore conclude that although there is little evidence that shareholder activism increases firm performance, this does not mean that the concept itself should be dismissed. On the contrary we believe that the success of hedge fund activists show that specialized actors can be quite effective in assuming the role of a governance mechanism.

5.2 Further research and discussion

Throughout the process of writing this thesis, a number of interesting areas have come up that we consider being in need of further research. Firstly, much of the previous research in this field has attempted to link shareholder activism with firm performance. Many economists have used qualitative approaches and looked at shareholder proposals, voting outcomes, take-over threats, press campaigns and so on in order to evaluate whether shareholder activism actually works as an effective governance mechanism, by examining firm performance and stock price. We suggest that more research should focus on the "new shareholder activism", investigating internal relationship building between shareholder activists and the board of directors through qualitative studies. Today, many shareholder activists use private channels to improve firm performance, like soft diplomacy or long-term relationship building with the company. These actions are often difficult to observe by an outsider, which gives rise to misleading results when evaluating the effects of shareholder activism. By conducting more qualitative research, in-depth interviews and other methods of information retrieval over a longer period of time, both from shareholder activists and the targeted firms, economists would be able to examine the full extent and effects of today's more complex activism. Secondly, we believe that the existing literature on shareholder activism and corporate governance could benefit from a sharper focus on how to make shareholder activism more effective from a legal point of view. We have in this thesis concluded that the effectiveness of shareholder activism is highly dependent on the legal environments. By proposing new legal rules in order to create an environment that enables different types of shareholder activists to work as an effective governance mechanism, governments will be pushed to instigate changes that will benefit institutional investors, minorities and the financial markets on a whole. We also believe that hedge fund activist funds are highly interesting candidates for further research.

5.3 Limitation in research and critical evaluation

Due to the fact that our thesis includes some limitations, it is important to include a critical evaluation of the results. First of all, much of the literature is based on American rather than European studies. As the laws and regulations differ between countries, it is difficult to draw a general conclusion. In order to avoid this problem we have focused on common rules that are very similar between countries. Moreover, since we have done a qualitative study, it is complicated to defend the conclusions that we have made. The results are based on the literature we have chosen. Even though we have tried to be as objective as possible and include many different views, the thesis may still include some subjective bias. Our aim has been to give the reader a broad summery of the subject and analyze its implications. Naturally, this thesis does not aim to include all aspects of shareholder activism and corporate governance.

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Definitions

Corporate governance
The exploitation and use of organizational resources as well as the resolution of conflicts between parties within the corporation

ERISA
1974 Employment Retirement Security Income Act

Exterior agency problems
Fund manager's tendency to focus on outperforming competitors rather than enhancing shareholder value.

Gadfly
Active individual investor

Interior agency problems
Management prioritizing its own benefit rather than shareholder value.

Jawboning
When investors decide an executive or board member is unsuitable and demands his or her replacement.

Monitoring
Although monitoring at first sight implies the passive acquisition of information, we use it to describe all value-enhancing activities; therefore it basically constitutes as a synonym for shareholder activism.

Poison pill
This is a defensive measure against hostile takeovers. They usually work by implementing rules that allow existing shareholders to purchase either the firm's own shares (flip-in) or the takeover firm's shares (flip-over) at a discount. The dilutive and value draining effect of the poison pill discourages takeover attempts.

SEC
US Securities and Exchange Commission

Shareholder activism
Shareholder activism can be understood by analyzing the intensity of monitoring by traditionally passive institutional investors. The concept can be divided into two phases: an investigative phase which seeks to ascertain whether the target firm is maximizing shareholder value while the active phase tries to change firms that fail to do so.

Shareholder proposal
A governance mechanism formed by the US Securities and Exchange Commission, SEC, under division 14 of the Securities and Exchange Act of 1934. Presented via a shareholder, proposals are short reports requesting the management to follow an explicit route of action.

Staggered boards
Staggered boards, also called classified boards, are a system where board members are divided into different classes with different term lengths. Elections are usually performed annually but only for those board seats whose terms have run out. This means that it is impossible to replace the entire, or even a significant part, of the board at one time.