This is a collection of five blog articles on the subject of governance and pensions schemes written by Con Keating (BrightonRock Group, Long Finance Advisory Board,) and published on the Long Finance blog the Pamphleteers.

Blood Letting

The advent of investment consultants into fiduciary management raised some concerns, not least over conflicts of interest. The proliferation of descriptive titles for these activities also raised concerns, as in addition to the possibility of finer distinction, this practice also serves to obscure. It reduces the fiduciary management classification to a fuzzy, ill-defined set.

One of the key points in the sales pitches for fiduciary management was that this delegation of powers would enable faster decision-making and the exploitation of rapidly passing opportunities in markets. No mention here of 'marry in haste, repent at leisure', which does have academic support. No mention either that such transient "opportunities" are speculations rather than investment; but , perhaps more importantly, no evidence has been offered that this short-term speculative behaviour can be achieved and aggregated to deliver superior long-term returns.

The recently published study by Jenkinson, Jones, and Martinez[1] (JJM): *"Picking winners? Investment consultants' recommendations of fund managers"* casts serious doubt on the ability of investment consultants to select managers. Of course, the fiduciary problem is somewhat different – here the selection is of securities not managed portfolios, but the linkages between these are strong. This JJM study is not unique – in 2001, John Woods and Mike Smith published a short paper "*Investment Consultants' Fund Manager Recommendations: Is There Any Value in Them*". This is far from an overwhelming body of evidence, but it appears that investment consultants are loath to provide data on their recommendations, and much more.

These findings do not appear to have surprised or shocked many. A survey by Professional Pensions, in response to the question: "*A study of US investment consultants has concluded that their manager recommendations add no value. Do you think this is true in the UK?"* , - reported that 47% thought it true and 26% did not know. This is by no means a scientific survey, but more than 60% of its population report themselves as being trustees or in closely related positions.

However, one finding from this latest study offers scope for further analysis. It appears that pension schemes do rather slavishly follow the recommendations of their investment consultants, which means that we may be able to infer the quality of that advice from the performance of pension funds. Given the relative performance of pension funds' overall investments, this does not appear to offer high hope of redemption.

The JJM paper examines the determinants of manager selection and finds that "*consultants' recommendations are driven partly by the past performance of fund managers, but more so by non-performance factors, ...*". The analysis of the use of soft and service factors in manager selection by investment consultants is both interesting and a source of concern.

[1] Jenkinson, Tim, Howard Jones and Jose Martinez, 2013, Picking winners? Investment consultants' recommendations of fund managers – http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2327042

Soft factors include such aspects as clear decision-making, capable portfolio manager, and consistent investment philosophy, while service factors include capabilities of relationship professionals, usefulness of reports prepared by the fund manager, and effective presentations to consultants. Quite how this latter point is relevant to investment performance is something of a mystery, though its value to consultants is clear. The cynic might well view the use of soft factors by investment consultants as little more than the introduction of a little "magic" into a process which otherwise might be reduced to algorithmic analysis of performance data.

Indeed, consultants do examine fund managers at considerable length and depth; far beyond simple investment performance metrics. Disclosure of changes of staff, losses of investment mandates and much more are routinely required. This raises some obvious questions. Where are the disclosures of changes of staff, the loss of advisory roles and similar soft factors from investment consultants?

Many have attributed the use of investment consultants to the relations of trust that develop between trustees and investment consultants. This is positively dangerous for trustees – trust that is not merited and honoured can be expected to result in rent-seeking behaviour by the trusted. The idea that the use of an investment consultant provides a shield for trustees seeking to alleviate their fiduciary responsibilities with respect to members is also suspect. Trustees may well use investment consultants for other purposes – the hand-holding of Lakonishok et al.[2] – but that does not explain why they follow the investment recommendations offered by consultants.

In common with credit-rating agencies, investment consultants have developed a role as gate-keeper – controlling the access of fund managers to pension funds. The problems that this created and its centrality is the recent crisis are well known in the case of ratings agencies. The investment consultancy variant has many negative overtones, from the suppression of innovation (few new fund managers make it into recommended lists) to a lack of heterogeneity among the pension system's investment portfolios. This lack of heterogeneity may even become systemically important, as many schemes invested in a particular fund may seek to exit at the same time on the downgrading of a consultant's recommendation. One minor embodiment of this gatekeeper role is the presence of investment consultants in the trustee meetings evaluating and selecting managers.

The JJM study notes that the funds selected by investment consultants are biased towards the large, and the tendency of large funds to underperform is well known. This might once have been described as "buying IBM" to avoid criticism, but IBM's travails in the past few decades have rendered that a less than convincing strategy. The report's findings in this regard merit reproduction: "*we find no evidence that consultants' recommendations add value to plan sponsors. On an equal-weighted basis, the performance of recommended funds is significantly worse than that of non-recommended funds, while on a value-weighted basis the performance is mixed, and the recommended and non-recommended products do not perform significantly differently from each other. The underperformance of recommended products on an equal-weighted basis can be explained by the tendency of consultants to recommend large products which perform worse. When we adjust for the different sizes of recommended and non-recommended products, we find that recommended*

[2] Lakonishok, Josef, Andrei Shleifer, and Robert Vishny, 1992, The structure and performance of the money management industry, Brookings Papers: Microeconomics

products still fail consistently to outperform non-recommended products. The same result holds when we adjust for possible backfill bias."

The Report ends with: "*Among the consultants whose aggregate recommendations we have analyzed, some presumably do better than others, and a knowledge of differential performance would inform a plan sponsor's decision about which consultant to appoint. Without this knowledge, plan sponsors are making appointments partly blind. An obvious policy response by regulators, or a market response by plan sponsors, is to require full disclosure of consultants' past recommendations so that such decisions are better informed and, as a consequence, their assets more efficiently allocated."*

There is an overarching criticism here. In the absence of such disclosures by consultants, competition between consultants is suppressed. In fact, it is clearly in the interest of those consultants who do add value to disclose and demonstrate their value-added. To be credible, of course, such evaluations of value-added need to be independent of the consultant concerned.

The asset management industry has been subjected to many criticisms of their costs, fees and performance in recent years, with politicians promising to intervene with regulation. The investment consultancy industry can expect a similar treatment. It is in the interest of investment consultants to pre-empt that by full and fair disclosure. In the absence of this, it is clearly incumbent on trustees to reconsider their position. The required statement of investment principles is clearly incomplete without reference to the basis of advisor selection – and the views of the Pensions Regulator on that may be interesting, in the Chinese sense.

There remain a number of questions; such as can anyone can systematically and sustainably add value and if they can, why are they functioning as advisor rather than principal? It seems that investment consultants do function in a manner comparable to doctors; but the open question is the medical technology being applied – is this that of blood-letting and leeches, or of more modern scientific practice, of both prevention and cure.

Trust and Commitment (published 25 October 2013)

Trust is notoriously difficult to define but the erosion of trust is one of the few diagnoses of the crisis that few dispute[3]. Somehow, the idea has grown that we can "rebuild trust"; unfortunately, this is a fallacy.

Trust oils the wheels of commerce and finance; it is an efficient solution to a wide range of problems. Simply put, in a world where trust is prevalent, more gets done; much of it collaboratively and co-operatively. The reality of our world is one in which both formal contracts and informal trust-based arrangements can co-exist to support the exchanges of business. Formal contracts introduce the state as arbiter of performance; while informal contracts rely upon trust and are enforced informally. Soft concerns, such as reputation and reciprocity, encourage performance and perhaps, penalise breach.

Trust requires the presence of a risk or hazard to be necessary. When we place our trust in another, we are committed and exposed to this hazard. We are vulnerable. Trust and commitment are synonyms. We are also exposed to the possibility of exploitation. Trust is

[3] This is not to say that alternate explanations are not possible – for one see: C. Keating and B Marshall: *Trust and markets*, 2010

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redundant unless the hazard is greater than the gain from the operation. Trust is only required if a bad outcome results in disappointment and regret.

If we are prudent men, we place our trust only in those we deem trustworthy. This is a matter of judgement. The role of experience and repeated interactions as both evidence for this judgement and in building trust cannot be overemphasised; just look at the bonds that can form among soldiers who have seen action together.

There may be nothing that we can do to "rebuild trust", but there is much that we can do to enhance our own trustworthiness. The aspects of trustworthiness most relevant in the financial services sector are[4]:

- Competence
- Reliability
- Honesty

The challenge is to prove our trustworthiness. Most of us can certainly improve our competence and reliability. Of course, we can practice, demonstrate and signal all of these, which should increase the willingness of others to place their trust in us. Evidence, its transparency and disclosure are key. Information exchange between the parties allows them to surmount jointly the problems of interpretation of ambiguities, but this does add structure to the informal contract as this information exchange is usually a formal term of the contract[5]. In a fund management setting, the client relations officer as conduit is central.

In our exchanges and collaborations, we often use mixtures of contract form – formal for the foreseeable and informal for the unforeseen. There are also questions as to the degree to which these different forms are complements to or substitutes for each other. Substitutes are rivalrous.

Some have proposed the use of guarantees and collateral security as mechanisms to enhance trust, but this will not work. Reducing the hazard or consequence does not improve the degree of commitment or trust; rather it reduces it. These techniques may increase the number of transactions, but they increase their cost. These arrangements are substitutes for trust-based agreements and co-operations, and can be expected to crowd them out. These serve to increase our confidence rather than our trust.

Perhaps more subtle is the situation where formal and informal contract are intertwined. Fund management is a case in point: these services are sold on trust, but are evidenced by a formal contractual agreement. In dispute, they are only-too-often resolved solely on the formal contract and the legal system, leaving investors feeling that fairness and reciprocity have been thrown to the winds.

This is a particular illustration of the problems of institutional corruption. To quote Malcolm Salter[6]: *Institutional corruption ... refers to institutionally supported behaviour that, while not necessarily unlawful, erodes public trust and undermines a company's*

[4] See: http://www.ted.com/talks/onora_o_neill_what_we_don_t_understand_about_trust.html

[5] Terms such as the type of information, a minimum frequency of reporting and its degree of detail are usually specified. The exchange of information and actions based upon it can be difficult to co-ordinate due to institutional structure of the investor base. In the case of retail funds there can clearly be collective action problems. These are resolved in bond markets by the appointment of a Bond Trustee, whose role is both to monitor and enforce terms of the issue such as bond covenants.

[6] Salter, Malcolm S. - April 11, 2013 - Short-Termism at Its Worst- How Short-Termism Invites Corruption… and What to Do About It – Harvard Business School Negotiations, Organizations and Markets Unit - SSRN-id2247545

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legitimate processes, core values, and capacity to achieve espoused goals. Institutional corruption in business typically entails gaming society's laws and regulations, tolerating conflicts of interest, and persistently violating accepted norms of fairness, among other things. ..." There may be a very fine line here when dealing with innovation and arbitrage. The sale made based on trust which reverts to the fine print of the formal contract when troubled, is perhaps the classic illustration of institutional corruption.

Though the ability to extract information from the parties in order to verify performance is central to its ability to form judgements and set remedies, it should be realised that a court's ability to impose sanctions to extract information must be limited. If it were not, it could become unaffordably expensive and undermine the original rationale for writing a formal contract in the first place. Standards have a role here as benchmarks and as devices to minimise enforcement costs. Open standards bring the additional advantage that they also benefit informal contracts.

Enforcement in an informal situation can take a number of forms. The cessation of business or a tit-for-tat strategy are perhaps the best known and can even work in a multilateral setting. Others are concerned with morality; on these grounds, many do not exploit vulnerabilities even when they have clear gains available and no threat of retribution. Social ostracism can also serve to encourage performance and offer remedy of informal arrangements, as indeed it did widely in the clubby world of the old City of London. It is often superior to use informal enforcement practices even when the formal court processes are available as it is usually cheaper and does not require further expenditure.

One of the major problems for informal contracts lies with high levels of noise and uncertainty where the true signals and information may become unobservable, and even be misinterpreted. Here, rigid tit-for-tat strategies must be replaced by more generous versions that forgive some apparent transgressions.

When trust is honoured, it is self-reinforcing and develops naturally into fruitful long-term relations. It is a key element in any transition to a world where the short and long-term are well balanced and generosity can be justified by the (asymmetric) gains to be had from its development.

When trust is abused, relationships should end. This is the world of 'lemons' and agency problems[7]; it is the world of contract and negotiation – with all that costs, and entails. We should also be cautious in proposing formal sanctions and requirements. These can overwhelm the informal process and the best-known example of this was the introduction of a fine for parents who were late collecting their children from school, which had the counterproductive effect that more parents now felt free to collect their children later. There is little doubt that this form of behaviour may occur in financial services – many have argued that the advent of explicit financial services regulation led directly to self-interested income maximising behaviour. We should be aware that the more formal a rulebook the more it suppresses informal arrangements.

This is not to propose that regulation be entirely principles-based for there is a paradox of trust here also. To quote Julia Black[8] "*Principles-based regulation is based upon trust that it alone cannot create, though it can facilitate its development. ... Without trust, Principles*

[7] George A Akerlof, The Market For 'Lemons': Quality Uncertainty And The Market Mechanism, The Quarterly Journal of Economics, Volume 84, Number 3, August 1970, pp 488-500

[8] See Black J. "Forms and Paradoxes of Principles Based Regulation" LSE Law, Society and Economy Working Papers 13 / 2008

Based Regulation will never be operationalised; it will exist only in the text of the rule books, not in the way they are implemented."

The role of formal contracts in these mixed contracting situations is to create a governance framework that supports the informal arrangements. Statutory obligations do not have to crowd out trust and can reinforce it by supplying an independent arbiter of the performance of soft and informal arrangements. This is not the absolute regulation of the reorganisation of the LIBOR pricing mechanism, which is clearly a substitution. Rather it is the extension of fiduciary responsibility to the entire chain of investment advisors and fund managers supporting and providing services to the trustees of pension schemes. Here, the incentives to perform well are then well-aligned, and there are implicit covenants.

Much of the governance literature is concerned with the concept of engagement, for example between management and shareholders. When shareholders are trusting and committed, management should engage. If they don't, they are abusing trust and it is time to remove them.

There are some obvious signals of a lack of trustworthiness – a prime example is an asymmetry of disclosures. Investment consultant demands for details of changes in fund manager personnel and clientele must be matched by their own equivalent disclosures. The suppression of details of settlements made with disgruntled clients is another. The use of share buy-backs rather than special dividends to return capital to investors, which of course benefits managers where they have earnings-per-share related compensation, is yet another.

Men of integrity will be trusted, but they must also be distinguishable from the crowd. Trust must be earned, which begs the question: is it worth the effort? Well, a world where trust and commitment are predominant is not just a better economic world[9]; it is a better social world.

Promises, promises (published 5 November 2013)

The earlier article "Trust and Commitment" was necessarily short but prompted much reader response. In pursuit of brevity, it did not consider a number of things, for example, trust as encapsulated interest – we place our trust those whose interests contain our own. Indeed, there is also a corollary to this that we do not trust those whose interests differ from our own[10]. The weakness in this approach is the exogenous nature of these interests when the iterative endogenous characteristics are clearly of great importance. Familiarity breeds familiarity and encourages trust. There are questions over commitment and incentives for the trusted, particularly so under uncertainty.

Nor did we cover the idea of trust arising from evolutionary biology, ubiquitous though trust is in developed and even early societies. This is because we prefer to think of trust in the context of choice rather than as a consequence of evolution. However, we should remember that trust can influence not just what we <u>choose</u> to do, but also what we <u>can</u> do.

We should have distinguished between trust and confidence. Both concepts refer to expectations that may lapse into disappointments. We trust that markets will *function* as we expect but we have confidence in the *ability* of our doctor to cure our ills. The latter is a question of ability and related to the competence characteristic listed in the earlier article,

[9] In the absence of trust, people cannot even be expected to save or invest.
[10] We do not discuss here a related issue – the incentives to mislead during a relationship in pursuit of self-interest.

while in the former it is concerned with motivation or predisposition[11]. We can have confidence in the ability of the ATM to deliver cash, but we should also recognise that it does not have any functional flexibility, a characteristic of relations of trust.

For completeness, we should also have covered moral hazard and adverse selection in contracts. Moral hazard arises when we have incomplete information about the counterparties' actions; are they locking the car now that it is insured against theft? Adverse selection arises when we have incomplete information with respect to the counterparties' characteristics; was that illness present before the policy was written?

Among the volumes of philosophy on the subject of trust, there is a good workhorse description due to Annette Baier[12] that seems highly applicable in the context of financial affairs: "*For to trust is to give discretionary powers to the trusted, to let the trusted decide how, on a given matter, one's welfare is best advanced, to delay the accounting for a while, to be willing to wait to see how the trusted has advanced one's welfare.*"

In a fund management setting, not only does this bring the investor's timing of demands for accounting into question but also it raises the questions of active and passive misuse of discretion by the trusted. A good illustration of the passive is the practice of hugging an index when uncertainty is high, while charging active management fees.

Many of the responses from esteemed members of the legal profession concentrated on the suggestion in the earlier article that fiduciary responsibility should extend to all involved in the investment management chain. Most took issue with the idea that this should be soft and not overly defined and should not be restricted and defined by rules and regulations. They raised questions of duties of care, duties to negotiate in good faith, and duties of fidelity, among others and wanted to write far more extensive rules and regulations, which, of course, would be interpreted by a cynic as a desire to promote their own professional interests.

The question of the form of regulation is important. Coercion is a substitute for trust and in implementation could easily be asymmetric and destructive of mutual trust between fund manager and investor. While it ensures compliance within the specific context covered (under threat of explicit sanction), it also increases the likelihood of perfidious behaviour elsewhere. Information exchange and interpretation might then no longer be free and open. It would also be costly in terms of compliance and enforcement and reduce economic efficiency. In soft form, however, legislation can provide the governance framework that allows for the enforcement of agreements over rights that are commonly shared, but permits relations of trust to do the heavy lifting. This reduces the other, non-enforcement costs of legislation by allowing private monitoring and information collection and generation. We should also not forget that for the signals generated by someone wishing to demonstrate their trustworthiness must themselves be costly if they are to be credible.

It seems to us that these issues can be better dealt with by voluntary adoption of an ethical code. Just about all fund managers now publish and promote their investment philosophy. In all-too-many cases these philosophies are little more than collections of inanities; we believe in mean-reversion, we believe in fundamental analysis, and the like; recitations of a

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[11] There is an interesting and relevant illustration due to Luhman: As a participant in the economy, you necessarily must have confidence in money. Otherwise, you would not accept it as part of everyday life without deciding whether or not to accept it. In this sense, money has always been said to be based on 'social contract'. But you also need trust to keep and not spend your money, or to invest it in one way and not in others.

[12] *The Tanner Lectures on Human Values*, Princeton, 1991

particular investment creed – perhaps, a mind map. We will offer, as a straw man, a collection of principles for inclusion in this philosophy of ethics, which we believe will go far in promoting trust in investment relations, and obviate the need for fiduciary responsibility to be accompanied by yet another detailed rulebook.

It is clear that the forces of competition have led many fund managers and investment consultants to adopt the ad-man's practice of selling the sizzle rather than the sausage, leading to over-promising and disappointment. Promises have been the subject of vast amounts of philosophical thought; from Hume and Kant and Durkheim to the current generation. Here, we borrow heavily from Thomas Scanlon's 1990 "Promises and Practices"[13], which offers four principles:

Principle M: *In the absence of special justification[14], it is not permissible for one person, A, in order to get some person, B to do some act, x (which A wants B to do and which B is morally free to do or not do but otherwise would not do) to lead B to expect that if he or she does x then A will do y (which B wants but believes that A will otherwise not do) when in fact A has no intention of doing y if B does x, and A can reasonably foresee that B will suffer significant loss if he or she does x and A does not do y.*

This amounts to little more than a statement that we will not mislead and is a moral standard. The open question is really the degree to which an investor has come to rely upon this promise.

Principle D: *One must exercise due care not to lead others to form reasonable but false expectations about what one will do when there is reason to believe that they would suffer significant loss as a result of relying on those expectations.*

This introduces reciprocity and commitment to the relation between fund manager or investment consultant and the investor. In many regards, it can be seen as a variant of First Do No Harm. It can be extended to include more developed ideas, such as loss prevention.

Principle L: *If one has intentionally or negligently led someone to expect that one will follow a certain course of action x, and one has reason to believe that that person will suffer significant loss as a result of this expectation if one does not follow x, then one must take reasonable steps to prevent that loss.*

The notion of proportionality is introduced by the idea of *reasonable steps*, which might take no more than the form of warning the investor. The principle is in fact neutral between warning, fulfilment and compensation. It would though doubtless appeal to those investors who experienced style drift in their hedge fund investments and suffered resultant losses. It is arguable that even this principle is not sufficiently comprehensive; for example, it does not cover an investor's foregone opportunities, and we may move to a duty of fidelity:

Principle F: *If (1) A voluntarily and intentionally leads B to expect that A will do x (unless B consents to A's not doing x);*

(2) A knows that B wants to be assured of this;

(3) A acts with the aim of providing this assurance, and has good reason to believe that he or she has done so;

[13] *Philosophy and Public Affairs,* Volume 19, Issue 3 (Summer 1990), pp 199-226

[14] Such justification need not take the form of considerations that override the obligation described by this principle, but can also include reasons for setting it aside, as for example in some forms of legitimate competition in which it is permissible to lead others to form false expectations about one's intentions.

(4) B knows that A has the beliefs and intentions just described;

(5) A intends for B to know this, and knows that B does know it; and

(6) B knows that A has this knowledge and intent;

then, in the absence of some special justification, A must do x unless B consents to x's not being done.

This introduces a *right to rely* upon the expectations created. It would clearly introduce a need for ongoing open discourse between investor, consultants and managers. It is clear that these principles, if adopted, could offer a governance framework for an extended fiduciary responsibility and result in both increased trust and independent arbitration by the court system. Clearly, these principles are complementary to one another rather than mutually exclusive.

Whether we like it or not, the formation of agreements between investors, fund managers and investment consultants has a moral dimension. Clearly, such agreements bring with them obligations and duties, which only-too-much of the fine print of investment management and consultant contracts seeks to avoid and evade. The signal that such agreements send is that the counterparty is not trustworthy. Trust will not flourish in that environment.

Perhaps the most important point is that if the industry embraces these principles, then fiduciary responsibility does not have to be accompanied by yet another thick rulebook and phalanx of regulators. Though the threat of statutory intervention is reason enough to adopt such approaches, there is a more basic market rationale. If London does not take this approach, with its disclosure and transparency, it will simply lose out to those markets overseas that do; enlightened self-interest should prevail.

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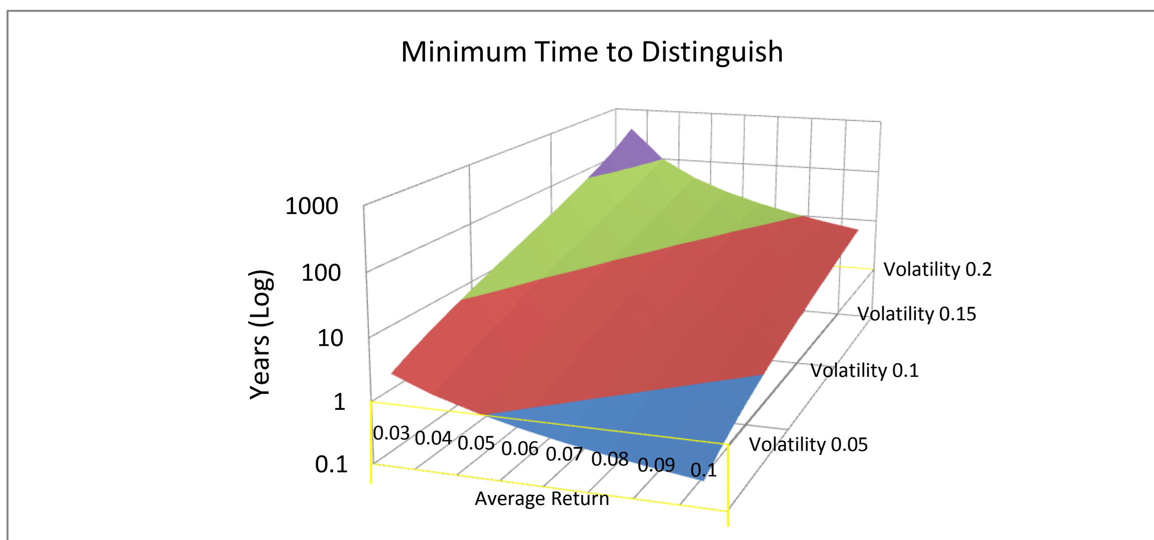
Computer says No

Among the more difficult questions, facing us in the reconstruction of a trusting world is the role of technology. Undoubtedly, systems can supply us with real-time data on the disposition of our investments and with near-real time valuation of these portfolios. However, this is data rather than information.

The first concern with such exchanges of data must be the separation of signal from noise and, when market prices are used for valuation, the levels of noise are surprisingly high, as is illustrated below. This figure shows the length of time an investment must be held for the signal to be equal to the noise, which is the usual minimum standard for distinction between signal and noise to be feasible. It is evident that distinction at frequencies of less than one year is only feasible with high return, low volatility assets, but that is precisely where the information is least valuable.



Technology supplies us with data, and to parse data into noise and information requires the use of a model. Different models can provide entirely different information. Though these models do not have to have formal statistical description, i.e. they can be mental mind maps, the use of different statistical models can illustrate the differences which may arise from the use of different models, and they can be radical.

In the context of relations of trust, where the resolution of ambiguity and uncertainty are the objective of interactions between trusted and truster, it is necessary for these two parties to share a common model for a shared interpretation of circumstances. This lies at the heart of mutual understanding. Transparency when it is just the exchange of data is insufficient.

Technology can, of course, increase our confidence. The ability of the ATM to operate competently and reliably is not in great doubt, which merits our confidence, but the ATM has limited functionality. It is bounded by the rules programmed into it, as well as its mechanical parts. But confidence and trust differ. The technology is incapable in conditions of ambiguity and uncertainty of the interactive deliberations and flexibility that are a central feature of informal contracts. In some regards, these dialogues may be viewed as the process by which new models are agreed by both parties.

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Ownership and Agency (published 2 December 2013)

Since at least Friedman's 1970: "*The Social Responsibility of Business is to Increase its Profits",* it has become common to refer to the shareholders of a firm as its owners, a mistaken view that leads to much confusion and wasted effort. On top of this misconception, in their 1976 paper[15], Jensen & Meckling compounded the matter by asserting that: "*the relationship between the stockholders and the managers of a corporation fits the definition of a pure agency relationship*."

A corporation in fact owns itself, in just the same way that we own ourselves. The corporation is a legal entity. Shareholders have rights over the residual assets of a corporation; but they certainly cannot take possession of or dispose of corporate assets for themselves, which is sometimes referred to as "capital lock-in". Most importantly, management is not the agent of shareholders but the agent of the corporation itself. Management does not owe a duty of obedience to shareholders. Shareholders usually also have rather limited voting rights, for example over the appointment of directors.

Many differing strands of theory and analysis now challenge this Chicago school paradigm of corporate finance and purpose. Among these[16] are concerns with market efficiency, the role of liquidity, and differences between the short and the long-term, as well as the differing preferences of universal investors versus undiversified actors, and director control as a form of mediation mechanism between shareholders' and other stakeholders' inclinations. This latter approach notes that directors rather than shareholders suffer opprobrium from the anti-social activities of the corporation. Taking a legal standpoint, Clark[17] summarizes the (US) law as:

(1) corporate officers like the president and treasurer are agents of the corporation itself;

(2) the board of directors is the ultimate decision-making body of the corporation (and in a sense is the group most appropriately identified with "the corporation");

(3) directors are not agents of the corporation but are sui generis;

(4) neither officers nor directors are agents of the stockholders; but

(5) both officers and directors are "fiduciaries" with respect to the corporation and its stockholders.

In economics, as noted by Colin Mayer, the reality is that: "*The failure of the conventional and unconventional paradigms is in providing a compelling description of the corporation"*. It is notable that, in practice, shareholders appear to be comfortable with directors being outside of their control, and often permit developments that reinforce their independence. It is clear that this relationship is not one of principal and agent. To a very large extent, this renders questions of shareholder engagement and influence matters of moral suasion and indirect influence.

This far, we have been considering large corporations with widely diversified shareholder bases; when we move to considering companies with concentrated ownership, for example within a particular family or the workforce, it is evident that greater influence may be

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[15] Michael C. Jensen & William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure", *J. Fin Econ.* 305 (1976).

[16] There are several approaches that emphasise the investment of other stakeholders in the firm, such as team production theory, which can be seen as an analogues of the lock-in of shareholders.

[17] Robert C. Clark, "Agency Costs versus Fiduciary Duties", *in* Principals and Agents: The Structure of Business, ed. Pratt & Zeckhauser, 1985)

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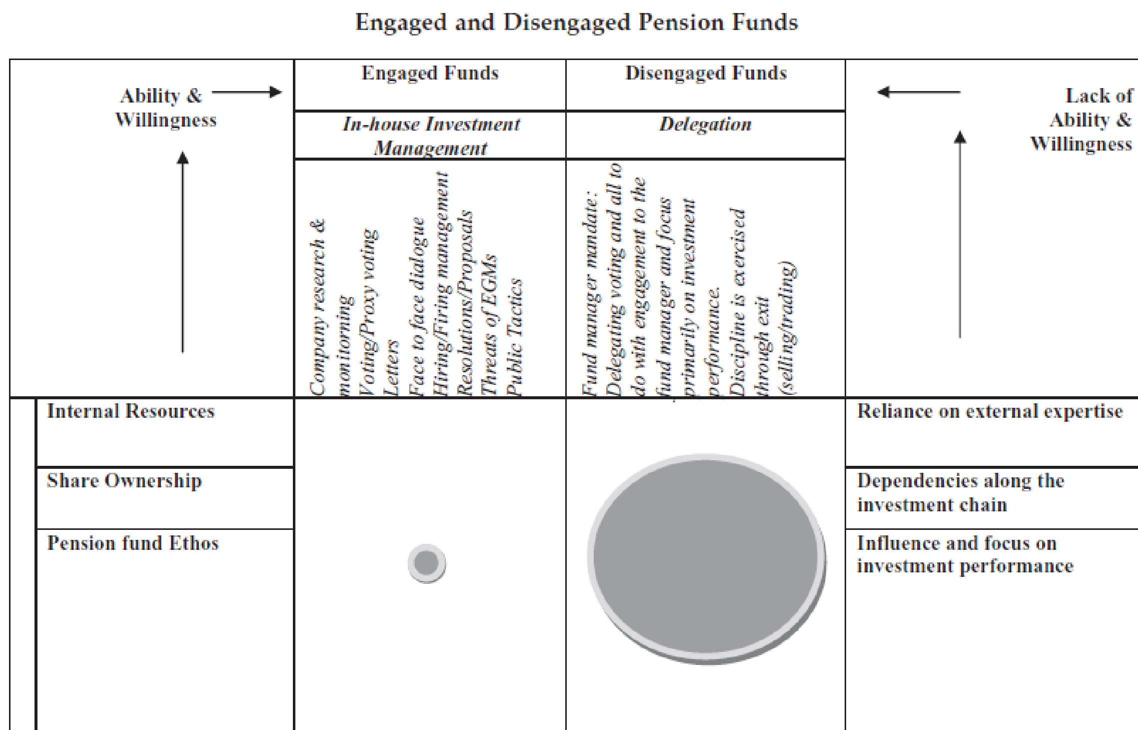
exercised. But even here, the relation is not the simple separation of ownership and control that lies at the heart of traditional agency theory. By extension, it is perhaps to be expected that very large self-managed investment institutions, which have meaningfully large investments in particular firms should seek to have greater influence over their management.

By contrast, the relation between a pension fund, its trustees, and its investment managers should be one of principal and agent. Note that this is not the case when the pension fund makes direct investments. These investment management chains can be extremely long, involving many advisors and intermediaries; this introduces room for many divergent interests to be interposed.

Empirical analysis of the actions of shareholder investors yields divergent results; some find increasingly engaged behaviour, while others find continuing uninvolved behaviour. A recent study by Anna Tilba and Terry McNulty[18], which examines many aspects of the investment chain, is most informative, as can be seen from the figure below, which is reproduced from their study:



It is notable that it is mainly large pension funds with in-house management that are active in engagement activity, while others appear to exhibit (rational) apathy. It is clear that much further research on the investment chain is needed.

Investment consultants perform a role as gatekeepers for trustee boards, limiting the access of fund managers to trustees; making recommendations to trustees as to which fund managers should be considered. This is a situation seen with credit rating agencies in the case of sub-prime securities, where the awarded AAA ratings served to grant access to particular classes of investor. Reputation used to be central to a credit rating agency's

[18] Anna Tilba and Terry McNulty, "Engaged versus Disengaged Ownership: The Case of Pension Funds in the UK" *Corporate Governance: An International Review, 2013, 21(2) 165-182*

ability to operate. However, when we have limited choice, then it may be perfectly rational for the agency to be unconcerned with reputation, particularly when the rewards to ignoring reputational effects are very substantial. When the choice is limited, though some clients may vote with their feet, the loss is likely to be offset by the gain of clients leaving other agencies. It is clear that the investment consultants have made an analogous decision with respect to their provision of direct fund management services, for example with fiduciary mandates; they perceive the gains to be sufficient that the conflicts and reputational damage are outweighed.

The prospect of contagion from these market leaders to minor participants is obvious and can occur through bad apple mechanisms or by imitation; it is self-perpetuatiing flattery.

Perhaps the most worrying conclusion to this Tilba and McNulty study is: "*It is not clear as to what, and if at all or to what extent, these experts (actuaries, fund managers and investment analysts) are accountable to each other, or the fund.*" Nor is it clear what value, if any, is added by these advisors. It seems that the mutual commitment that fosters relations of trust is absent rather than predominant.

Tilba and McNulty also observe: "*These relationships are laced with divergent interests and influence dynamics, which explains why these pension funds give primary emphasis to fund investment performance ...*" Many schemes are, of course, manage their funds in manners intended to hedge variation on the present value of liabilities rather than seeking to maximise investment returns. However, the emphasis is on return performance. This is questionable as the assets held by a scheme are only intermediate goods; their role is to generate the income from which pensions may be paid. Any strategy that depends upon selling assets in markets to meet pension payments is highly dependent upon the future liquidity and performance of those markets; a process which is far from certain. In circumstances where a scheme is in cash-flow surplus and growing, the scheme should actually prefer lower prices since this allows it to buy future income more cheaply, and implies a lower cost of pension provision. For schemes in this position, the absence of dependence on market prices may the use of market prices in valuation and regulation suspect in extreme.

The analysis of scheme investment in terms of exit or voice leads to some rather different conclusions; for voice to be listened to, it needs to be committed, with exit foregone. Management is no longer concerned with maximisation of the share price, but rather with maximisation of earnings in a sustainable manner. Voice should also only be listened to when it supports the stakeholder or team commitment view of the firm. The gains to these long-term strategies are realised from an equitable distribution of earnings over the long-term. In the short-term, there may well be market relative underperformance, but that is a direct result of the myopia of markets. Let us not forget it is income, and income growth, that dominate the long-term returns to investment.

Accountability, Transparency and Governance (published 8 January 2014)

The Royal Bank of Scotland's latest IT fiasco gave us an informative broadcast sound bite, the flustered and irate depositor who "could not withdraw my own money". If there was ever any doubt on ownership, this clearly resolves it. All of the holders of corporate liabilities have valid ownership claims. The issue becomes one of degree.

Creditors may have limited rights in the course of ordinary trading by a company, which covenants and warranties serve to protect, but with corporate distress, they can rule the roost. In some regards, the priority of their claims gives creditors a superior claim to

ownership of company assets. Property rights over a resource merit far more thought than their elementary listing: the right to choose the use, the right to the services of, and the right to free exchange of the resource; many different degrees of ownership can co-exist within a company's capital structure. It is clear that the issue of ownership and influence over the directors and governance of a company involves a complex co-ordination problem between classes, and their members, of owners, which is far from the simple principal and agent world of Jensen and Meckling.

Moreover, the question of ownership goes much further. In much the same way that commerce can give rise to intangible assets, a company can have intangible liabilities, from which the stakeholder view of governance emerges. Trust is a fundamental component of these intangible, informal "contracts".

In the wake of the crisis, some have argued for a return to previous forms of institutional organisation, the partnership, mutuality and state ownership, some for a plurality of institutional forms. While these may resolve some of the co-ordination issues, they bring with them other difficulties; a partnership interest may not usually be sold without the consent of the other partners. In large part, the decline of the partnership appears to have resulted from the perceived need for scale and external capital resources. In retrospect, demutualisation appears to have been little more that a fad, principally benefitting insiders.

Transparency is often advanced as a panacea in the trust and governance debates; with requirements for more and more disclosure to ever-wider "stakeholder" groups. But, ever more disclosure does not ensure any increased comprehension by these interest groups, and can even serve to inform rivals. Moreover, disclosure requirements can result in perverse behaviour. To quote Onora O'Neill: "*Misplaced transparency requirements can damage good work on policy, sound management, institutional integrity, and even democratic process*." and "*...this sort of transparency is not always a necessary and never a sufficient basis for accountability to wider publics.*" In the pathological limit of total disclosure and transparency, trust may become redundant.

The accompaniment to this has been the imposition of a culture of management accountability. While not in itself objectionable when applied intelligently, all too much has not been – targets and proxies chosen that poorly reflect the real services and products produced – the process of accountability management impinging upon the process of production - and targets being subjected to manipulation. It is important to recognise that these processes of accountability and audit shape the processes and practices of the institution. The monitors come to dominate the productive workers. In this world, regulatory oversight reduces to control of control systems. Such systems displace rather than bolster trust, and trust is needed by them if infinite regress (overseers of the overseers of the overseers etc.) is to be avoided. This is not to say that high quality systems of accountability cannot be devised; the required attributes are clear – they should be informed, independent and intelligible. However, we need to recognise that systems of accountability and audit are about what a firm has done, and not about how that firm does its business, which is the province of corporate culture and business ethics.

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