CORPORATE GOVERNANCE AND INSTITUTIONAL INVESTORS: IMPLICATIONS FOR LATIN AMERICA*

LAURA T. STARKS**

ABSTRACT

This paper provides an overview of the role of institutional investors in financial markets and in particular their role in the governance of corporations. The paper presents the theoretical and empirical evidence regarding the consequences of institutional investor trading and ownership on aspects of financial markets such as stock returns, volatility and response to corporate announcements. Also included is evidence concerning corporate governance and institutional investor monitoring. The paper concludes with implications of this evidence for the evolution of financial markets and corporate governance in Latin America.

Key words: Institutional Investor, Corporate Governance, Latin America

JEL classification: G34

RESUMEN

Este artículo provee una revisión bibliográfica sobre del rol de los inversionistas institucionales en los mercados de capitales y, en especial, su rol en el gobierno corporativo de las empresas. Se presenta evidencia teórica y empírica con respecto a las consecuencias de las transacciones de inversionistas institucionales y de su participación en propiedad de empresas sobre el mercado financiero, en aspectos tales como rentabilidades, volatilidades y respuestas a anuncios corporativos. También se analiza evidencia concerniente al gobierno corporativo y monitoreo por parte de estos inversionistas. El artículo concluye analizando las implicancias de esta evidencia sobre la evolución de los mercados financieros y el gobierno corporativo en Latinoamérica.

* I would like to thank Eduardo Walker, Fernando Lefort, Robert Parrino and Kelsey Wei for helpful comments.
** University of Texas at Austin
The governance or control of a corporation in terms of its goals, actions and outcomes derives from a variety of factors. Although generally the managers have direct day-to-day control over the corporation, their actions are constrained by policies set out by the board of directors, contractual agreements with employees and lenders, existing laws and regulations in the country (or countries) in which they operate, the treatment of their stock price by investors, and their competitive environment. In recent times there has been an evolution in corporate governance as many of these factors have been changing. This evolution has been particularly strong in Latin American countries where the banking, capital markets and legal systems have been undergoing dramatic adaptation.

Gillan and Starks (1998) define corporate governance as “the system of laws, rules, and factors that control operations at a company.” They go on to point out that a firm’s governance is the set of structures that provides the boundaries for the firm’s operation. This set of structures includes not only the participants, such as workers, managers, and suppliers of capital, but also the returns to those participants and the constraints under which they operate. Shleifer and Vishny (1997) focus their definition of corporate governance on the economic interests of the participants. In particular, they refer to corporate governance as dealing “…with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment.” Similarly, Zingales (1998) defines corporate governance as “…the complex set of constraints that shape the ex-post bargaining over the quasi-rents generated by the firm.”

The need for such a governance system derives from the conflicts of interests that exist among the participants (stakeholders) in a corporate structure. These conflicts of interests (often referred to as agency problems) develop because of different goals and preferences on the part of each participant and because of the lack of information regarding each participant’s information and actions. As early as Berle and Means (1932) researchers were interested in the separation of ownership from the management in the corporation and the consequences of this separation on the firm’s activities. This line of research has continued in the analysis of the rights of the contracting parties within a firm’s organization and their effects on managerial and owner activities (Jensen and Meckling, 1976; Fama and Jensen, 1983).

The influence of the various parties to the corporate governance system has been a central issue in the finance and economics literature. In order
to gain a better understanding of the potential influences on Latin American corporations as the factors of corporate governance are evolving, this paper focuses on the role of institutional investors in monitoring the firm and the implications of this role in light of the changing business environment in Latin America. After discussing the role of institutional investors in the next section, the following section considers the interrelation between institutional investors and the other factors of corporate governance. The consideration of institutional investors and corporate governance is an important focus for Latin America because of the rapid rise in institutional investment, both domestically from the privatized pension systems and internationally from the increasing foreign investment.

I. INFLUENCE OF INSTITUTIONAL INVESTOR OWNERSHIP AND TRADING

In many countries institutional investors have become a dominant presence in financial markets. In the United States, institutional investment grew from 6.1 percent of aggregate ownership of equities in 1950 to over 50 percent by 1999 (Board of Governors of the Federal Reserve System, 2000). The character of the U.S. institutional ownership has changed as well, with shifts in the relative importance of bank trust departments, pension funds, mutual funds, insurance companies, and endowment funds. Today independent investment advisors (primarily for pension funds), mutual fund advisors, and bank trust departments control the majority of institutional assets in the United States.

Assets held by institutional investors have been growing in other countries’ financial markets as well. For example, by the mid-1990s, institutional investors owned 76.5 percent of outstanding equities in the U.K., 59.8 percent in France and 39 percent in Germany. Further, the growth of total institutional financial assets in each of these countries grew by well over 50 percent over the 1990-1995 time period (Conference Board, 1998). For Latin American countries, pension reform has had a significant effect on the financial holdings of institutions and the capital markets. According to Walker and Lefort (2000), in Chile the domestic pension funds held over 50 percent of outstanding government, corporate and mortgage bonds by the 1990’s and over 10 percent of equities. Further, according to Iglesias (2000), by 1999, pension fund and life insurance
companies’ financial holdings represented over 10 percent of the total savings in Chile. Similarly, pension reform in Argentina and Peru has resulted in significant growth in institutional investment in those countries as well, although not as much as in Chile.

In many countries besides the increased investment by domestic institutions, there was also an influx of foreign capital, represented primarily by foreign institutional investors. For some countries the foreign institutions held more shares than did the domestic institutions. For example, Mexico’s stock markets had over 30 percent foreign investment in its market, while its domestic mutual fund industry held about 1 percent.

Besides being primary equityholders, institutional investors are also responsible for the major proportion of the trading volume in equity markets. For example, block trades account for at least 50 percent of the trading volume on the New York Stock Exchange (NYSE) (Conference Board, 1998). Further, in their sample of intraday NYSE trades, Sias and Starks (1998) document that institutional investors are responsible for 80 percent of the trading volume, implying that the institutions’ influence can be waged not only through direct contact with corporate management, but also through their trading. In fact, the authors show that institutional investors’ importance in trading is not limited to those stocks primarily owned by institutions. For example, for the stocks in their sample with the least institutional ownership (2.4 percent of the firms’ shares), institutional investors still account for over 40 percent of the share trading volume. Similarly, Sias (1996) has shown that institutional investors are as important as individual investors in the trading of closed-end fund shares, even though for the closed-end funds in his sample, institutional ownership is less than 5 percent.

The evidence regarding the effects of institutional trading is not limited to the United States. Walker and Lefort (1999) find that the pension fund reform in Chile, which led to greater institutional involvement in the financial markets, resulted in increased liquidity in the markets.

Given the dominant presence of institutions in equity ownership and trading, it is perhaps not surprising that these investors have been associated with a number of factors influencing stock returns. For example, Sias and Starks (1995, 1997) find that after controlling for size, greater institutional investor ownership is associated with a greater return autocorrelation and with a greater Monday effect. There is also some evidence that institutional
investors may trade together (i.e., engage in herding behavior) and that this trading includes positive feedback trading. Despite this evidence, however, most of the recent studies on this issue find little evidence that institutional herding is destabilizing to the financial markets.\(^1\) That is, the studies do not find that the herding behavior has negative consequences for the financial markets.

Evidence has also been found that institutional investor ownership is associated with certain different firm characteristics such as stock volatility (Sias, 1996) or a more complete information environment (Falkenstein, 1996). Gompers and Metrick (1999) argue that in the United States the shift in composition of equity ownership from individual to institutional investors has affected equity prices due to institutional preference for larger stocks. That is, they argue that the small firm return premium observed by earlier researchers has disappeared because institutions prefer large firms.

Although these studies of domestic institutional investor influence have been conducted exclusively on the U.S. markets, there is also some evidence on other countries. Walker and Lefort (1999) provide evidence that the growth in institutional investment in Chile (due to pension fund reform) is associated with greater market volatility. Iihara, Kato, and Tokunaga (1999) find that in Japan domestic institutional investors herd, but not as much as do foreign institutions that invest in Japan. Grinblatt and Keloharju (1999) find that in Finland, the foreign institutions tend to be momentum traders, buying past winner stocks and selling past loser stocks.

II. THE ROLE OF INSTITUTIONAL INVESTORS IN CORPORATE GOVERNANCE

Given the increasing influence of institutional investors in the financial markets, it is perhaps not surprising that they have become an important component of firms’ corporate governance as well. Before focusing on the role of institutional investors in particular, the special role that the stock market and its investors play in corporate governance should be recognized. First, the liquidity the stock market provides is important to investors, particularly the institutional investors and the initial providers

---

1. For studies of institutional investor herding or momentum trading behavior see Lakonishok, Shleifer and Vishny (1992), Nofsinger and Sias (1998) or Grinblatt, Titman and Wermers (1995).
of capital. For institutional investors the liquidity is important because it gives them the opportunity to quickly exit poorly performing firms as well as the opportunity to quickly take a significant position if an institutional investor wants to influence the company’s governance. Black and Gilson (1998) argue further that a well-developed and active stock market is critical to the operation of venture capital. The venture capitalist needs the opportunity to exit from a successful company through an initial public offering (which requires an active stock market). This is important in a corporate governance context because typically the entrepreneur gives some control over the firm to the venture capitalist. Entrepreneurs are willing to do this in order to obtain funds and because they are expecting to be able to reacquire control from the initial public offering and the venture capitalist’s exit.

The most important corporate governance benefits of the stock market arise from its participation in monitoring and providing information about the firm. The stock market’s monitoring role develops from the pressure the market puts on managers to make decisions that are in the interests of the stockholders. In addition, by providing an opportunity for takeovers, stock markets allow competing management teams to bid for control of firms. Thus, the stock market provides corrective action when managers are not performing sufficiently well (Fama and Jensen, 1983). A further primary benefit of the stock market, suggested by Holmstrom and Tirole (1993), is its ability to incorporate performance information which investors would not otherwise be able to infer from earnings information.

A. Institutional Investors as Monitors

The influence of institutional investors as monitors of a firm lies in their dual and somewhat conflicting goals of being large shareholders with some measure of control in the corporation and at the same time having a concern for the liquidity of their holdings. It has often been argued that institutional investors are ideally placed to be the principal monitors of firm management. Institutions are more likely to be large shareholders and as such have better incentives to become important monitors of the firm. As has been discussed by numerous authors (e.g., Shleifer and Vishny, (1986); Huddart, (1993)), because of high costs, only large shareholders would have the incentive to engage in active monitoring. The
reason is that although a monitoring shareholder would undergo the costs of closer monitoring, all shareholders would benefit from this monitoring. This “free-rider” problem implies that only a shareholder that could incur substantial benefits from the monitoring would choose to expend the resources for the monitoring. Black (1992) argues further that institutions should take on this role of more active involvement. Given U.S. laws, the more active involvement could only occur in institutions are allowed to hold larger stakes in companies than current regulations permit and if the institutions are allowed to team up with other institutional investors in order to be a more important factor in corporate governance.

A contrasting argument is that liquidity is more important to institutional investors than is monitoring (Coffee, (1991); Bhide, (1994)). According to this argument, institutions are more concerned about the liquidity of their investments than building up the concentrated ownership that would be required to have an influence on corporate decisions. Bhide argues that the strong liquidity of U.S. markets actually impedes institutional involvement in corporate governance because it is less costly for the institutions to sell firms that are in need of active involvement.

Kahn and Winton (1998), Noe (1998), and Maug (1998) discuss these tradeoffs between liquidity and control further. According to Kahn and Winton, institutions must explicitly consider the tradeoff because the profits from speculation are directly affected by the costs of monitoring (which consist of more than the direct intervention costs). They show that whether an institution becomes actively involved depends on firm characteristics that influence whether the benefits of increasing the value of the institution’s holdings in the firm outweigh the costs to the trading profits.

Noe (1998) shows that a core group of institutional investors with the goal of monitoring the corporation and preventing managers from engaging in opportunism can naturally develop under the U.S. structure of corporate governance. According to Noe, institutional investors are motivated to monitor managers because they can gain from the monitoring, even in the presence of free-rider problems, costly monitoring, and lacking any initial stake in the corporation. He further suggests that if the informed institutional investors increase the size of their shareholdings, that is, increase the concentration of the stock, it may actually increase liquidity by lowering bid-ask spreads.

Maug (1998) argues that the impact of liquidity on the control of a
firm can actually be positive. Although liquid stock markets make it easier to sell a large ownership position, they also make it easier for investors to build up large positions in a firm and profit from increasing their monitoring activities.

In the United States, some institutions have become increasingly active in trying to influence the governance of the firm. Beginning in the mid-1980’s, public pension and union funds adopted an activist role in their investments, attempting to change corporate governance. Their primary activities were to submit shareholder proposals at corporations’ annual shareholder meetings, negotiate with corporate management, and publicly target corporations through the media.2 The empirical evidence as to whether this public pension fund activism has been successful is mixed. With regard to certain issues, such as poison pills, researchers have found significant stock price reactions around the announcement of a shareholder proposal to remove such pills. On the other hand, there is little evidence that public activism has improved the firm’s operating or stock market performance over the longer term.

Besides public pension funds, some private pension fund and mutual fund advisers have also been working behind the scenes to influence corporate governance. (See, for example, Myerson, (1993); Pensions and Investments, (1993); Directors and Boards, (1997)). There is no direct evidence on the success of these interventions, but a study of 45 private negotiations between one public institutional investor and its investments gives perspective. Carleton, Nelson, and Weisbach, (1998) found that the institutional investor was able to reach agreements with the targeted firms over 95 percent of the time and that in at least 87 percent of these cases, the targeted firms subsequently took actions to comply with these agreements.

Even institutions that choose to sell their shares rather than trying to instigate change in the firm can have an effect on the corporate governance. As pointed out by Parrino, Sias and Starks (2000), there are several potential effects from institutional selling of shares: downward price pressure due to supply-demand effects, information signals to other investors, and changes in shareholder composition. The first effect is supported by empirical evidence that shows heavy institutional selling can put downward

---

2 For further studies on institutional investors and shareholder activism, see Gillan and Starks (1998, 2000) or Black (1998).
pressure on the stock price (e.g., Brown and Brooke, (1993)). Alternatively, the institutional selling may be viewed as a signal of bad information, causing other investors to sell as well, and depressing the stock price. Finally, the composition of the institutional investor types holding the shares may change, for example, from institutional investors with a long-term focus to investors with a more myopic view. This last effect may be important to directors if the type of institution holding the stock affects share value and/or management of the company.

Parrino, Sias and Starks (2000) find those firms that fire their top executives have a significantly greater decline in institutional ownership in the year prior to the CEO turnover than do firms that experience voluntary CEO turnover. These results are consistent with the hypothesis that institutional selling influences decisions by the board of directors - institutional investors selling a stock increase the likelihood a CEO is forced from office. Further, the authors find that greater decreases in institutional ownership are associated with a greater probability of an outsider being appointed to succeed the CEO. This indicates that directors are more willing to break with the current corporate management and institute change.

Based on the relation between a firm’s aggregate institutional ownership and its R&D investment, Bushee (1998) concludes that institutions overall serve a monitoring role in reducing pressures for managers’ myopic behavior. However, he concludes that the strength of this monitoring role varies across types of institutional investors in that institutions with high turnover and momentum trading encourage managerial myopic behavior. Using R&D expenditures as well as property, plant and equipment expenditures, Wahal and McConnell (1999) reach a somewhat different conclusion, that regardless of the investment style of the institutional investor, there is no evidence that institutional investors contribute to managerial myopia. In fact, according to these authors, it appears that they reduce pressure for that type of behavior. Similarly Hartzell and Starks (2000) find evidence that suggests that institutional investors provide a monitoring role in the choice of executive compensation for a firm. They find a positive association between institutional ownership and the

---

3 As noted by the authors, these results are also consistent with the hypothesis that institutional investors are better informed than other investors, and thus become net sellers over the period prior to forced turnovers when these firms typically experience negative market-adjusted returns.
pay-for-performance sensitivity of a firm’s executive compensation. Further, this relation is stronger when there is more concentration in the institutional ownership, implying that institutions have more influence when they have larger proportional stakes in firms.

The ability and benefits of institutional investor monitoring is recognized by governmental regulations as well. For example, in the United States, the Labor Department, which has oversight responsibility over corporate pension funds, advocates that pension fund administrators should vote their proxies as part of their fiduciary duty. Further, the Department states that part of a pension fund’s responsibility is to actively monitor and communicate with corporate management if such activities are likely to enhance the fund’s holdings. Similarly, in Chile, pension funds are required to vote proxies by law (Iglesias, (2000)).

B. The Monitoring Role of Institutional Investors in contrast to the Monitoring Role of Large Blockholders

Besides institutional investors, other investors who are large blockholders, such as individuals or family groups, can also fill the monitoring role of a large shareholder. The family group as a large blockholder is particularly applicable to Latin American markets where family groups play an important role in firm ownership. (It should be noted that the role the literature has envisioned for the large blockholder tends to be one in which the large blockholder is not an insider, but rather is independent of management and is active in monitoring the firm. This may not be the case with many family group owners.) Gorton and Kahl (1999) differentiate between the monitoring role of institutions and individual large blockholders. According to Gorton and Kahl, the institutional investors provide only imperfect monitoring because of their own internal agency problems. Individual blockholders provide better monitoring but since there are insufficient individual large blockholders, the imperfect monitoring of institutional investors is still beneficial.

A recent study analyzes the influence of the large blockholder (Bethel, Liebeskind and Opler,(1998)) by investigating the relationship between purchases of large blocks of shares and subsequent corporate performance. They particularly focus on large block purchases in which the investor announces an intention of seeking changes in the firm. The authors
document that these activist investor block purchases are followed by corporate restructuring activities, such as increases in divestitures of subsidiaries, share repurchases, and decreases in mergers and acquisitions. They also find evidence that corporate performance improves after an activist share block purchase. Their results lead them to conclude that the market for partial corporate control helps to mitigate the agency problem between managers and shareholders.

A further aspect of the large shareholder is when that shareholder is a lending institution or another corporation (common in countries with extensive corporate crossholdings such as Japan). First consider the role of the institution that is a lender.

Previous research has argued that lenders have a unique position in a firm’s corporate governance. Their position derives from their ability to monitor the corporation through their information and control abilities. In particular, the argument is made that banks have a comparative cost advantage in monitoring firms and that this monitoring is valuable in reducing the agency costs associated with debt financing. This cost advantage comes in particularly from the banks’ access to inside information (in contrast to bondholders who do not have access to such information) (Fama, (1985)).

There is extensive evidence concerning the role of lenders as equityholders in countries that do not have restrictions on equity investments by financial lending institutions. For example, in the U.S., banks have been prohibited by law from holding equity in a firm, but in Japan, banks take very large equity positions in the firms to which they lend. One possible outcome of these differences in restrictions is that the agency problems in Japan would be less than in the U.S., everything else equal. Prowse (1990) investigates this issue and concludes that agency problems in Japan are lessened by the Japanese lenders’ equity holdings. He bases this conclusion on his finding of a significant negative relation between debt ratios and firms’ potential for risky, suboptimal investments for U.S. firms and no significant relation for Japanese firms. The implication of these results is that through equity positions, lenders can contribute positively to a firm’s performance. An analysis that combines the role of outside director and lender is a study by Kaplan and Minton (1994) of outside appointments of former bank employees to boards of directors in Japanese firms. These authors conclude that banks (along
The presence of institutional shareholders with corporate shareholders are an important aspect of corporate governance in Japan. Such evidence on causation that arises from studies of comparative corporate governance structures and its effects should be viewed with caution. These differences in bank equity holdings do not arise in isolation from other differences in corporate governance between the United States and Japan. A second caveat to these results is that lenders may have different goals from other types of shareholders. Thus, it is not clear that lender equity positions would uniformly benefit corporate governance and firm performance.

III. EVOLUTION OF THE CORPORATE GOVERNANCE SYSTEM

As court decisions, laws, and institutional investor frameworks are continually evolving, changes in the corporate governance structures vary as well. The legal framework in Latin American countries sets the base for corporate governance in each country (La Porta, Lopez-de-Silanes, Shleifer and Vishny, (1997)) and as the legal and economic environments change, there will be change in the corporate governance structures in these countries as well.

There are several critical issues in how the presence of institutional investors in the Latin American firms’ corporate governance systems will evolve. First is the degree of interrelation among the different factors of corporate governance. Second is the increasing presence of foreign institutional investors. Third is the interaction between the legal system and institutional investment. Fourth is the interaction between institutional investors and large blockholders.

A. Degree of interrelation

A critical issue as to how the corporate governance systems evolve is the degree of the interrelations across the mechanisms, in particular, whether these mechanisms are substitutes or complements. Morck, Shleifer and Vishny (1989) were among the first to address the issue of external versus internal mechanisms. External mechanisms are those that control firm actions from outside the firm. The primary external mechanisms are the
stock market, the takeover market, the legal system including regulatory law, and the product market. The primary internal mechanisms for control of the corporation are the board of directors, institutional shareholders, large blockholders, lenders and employees. Jensen (1993) maintains that these factors work together in controlling corporate management and Pound (1992) argues that the different factors change to substitute for each other when one factor, such as the takeover market, begins to wane.

Several empirical studies on U.S. corporations have assessed these theoretical arguments by examining whether changes in external mechanisms of control (e.g., the takeover market) are offset by counter changes in internal control mechanisms (e.g., board of directors). Mikkelson and Partch (1997), Hadlock and Lumer (1997) and Huson, Parrino and Starks (2000) examine top executive turnover across time in order to discern whether internal and external monitoring mechanisms are complements or substitutes. The evidence is mixed. Mikkelson and Partch and Hadlock and Lumer conclude that internal and external mechanisms do not substitute for each other. They find that the relation between firm performance and top executive turnover is weaker during periods of low takeover activity and they interpret this evidence as implying that the internal mechanisms do not offset weak takeover markets. Such an interpretation suggests that the corporate governance is hurt when active takeover markets wane. However, it should be noted that these studies examined time periods that were either relatively short (Mikkelson and Partch) or spanned a much earlier period during which internal corporate governance structures were considerably different from those that have evolved to exist in more recent times (Hadlock and Lumer). Huson, Parrino and Starks (2000) examine a substantially longer period of time, one that includes both active and inactive markets for corporate control and that includes periods in which there were substantial changes in the characteristics of internal monitoring mechanisms. They conclude that their evidence is consistent with the hypothesis that internal monitoring mechanisms do evolve to offset changes in the takeover market, suggesting that in fact the internal and external monitoring mechanisms can be considered as substitutes.

Latin American firms differ in that the monitoring mechanisms do not exist or interrelate in the same ways as they do in the United States environment, upon which these empirical studies are based. For example, there is not a strong takeover market currently in existence in the Latin
American markets (although one is starting to develop in some countries). The implication of the Huson, Parrino and Starks (2000) result for Latin American firms is that corporate governance structures could evolve efficiently, even without active takeover markets, if the internal monitoring mechanisms are doing their job. For example, monitoring by institutional investors or blockholders could make up for the lack of an active takeover market.

B. Increasing presence of foreign investors

Another important factor in the Latin American stock markets is the increasing presence of foreign institutional investors. Due to their increasing investments in these markets over the past decade, foreign investors have had and can be expected to continue to have a large influence on these stock markets. Such influence will affect the firms’ corporate governance either through direct intervention or through indirect supply-demand effects. Examples of the direct intervention include the efforts of the California Public Employees Retirement System (CalPERS) and TIAA-CREF to improve corporate governance systems in all of their holdings, including those companies that have foreign domiciles. This type of intervention may be limited because of the costs to the institutional investor, because of the limited number of institutional investors that participate in such activities and because of the restrictions on voting rights that are often afforded foreign investors. (To have an active voice, investors need voting power.)

The indirect supply-demand intervention could partially overcome these limitations. That is, in order to raise greater amounts of capital, firms may be motivated to change their corporate governance structures in order to attract more investors. The question of the influence of foreign investors is significant because they have become such a large component of many markets. Several authors have studied whether the presence of foreign investors has significant impacts on financial markets. For example, Bekaert, Harvey, and Lumsdaine (1999) find that after liberalization in an emerging stock market, capital flows to that market increase by 1.4 percent of market capitalization annually for three years after the liberalization and then the increase slows down. They also conclude that there is evidence of a permanent price pressure effect from these capital flows,
but that the actual return effect is not solely due to price pressure. Finally, they find that capital tends to leave more quickly than it arrives. Choe, Kho and Stulz (1999) study the actions of foreign investors in Korea for the year 1997 and conclude that there is evidence of herding among foreign investors. They find this result to be stronger before than during the financial crisis in Korea in the latter part of the year. The herding result is consistent with that of Iihara, Kato, and Tokunaga (1999) who study the Japanese stock market and find more herding by foreign investors than by domestic institutional investors. Choe, Kho and Stulz (1999) further examine whether foreign investors are a destabilizing influence on the Korean stock market and conclude that they are not.

In a review of the literature, Stulz (1999) concludes that opening a country to international investors decreases firms’ cost of capital without adverse effects on its securities markets. Specifically, he finds no evidence that volatility, contagion or destabilization increase following a liberalization of a country’s financial markets.

C. Interaction between legal system and institutional investment

The manner in which countries’ legal frameworks evolve varies across countries due to differences in the countries’ respective historical legal and financial systems. For example, according to Roe (1990), in the early part of the twentieth century, institutions in the U.S. became active in the governance of corporations in which they owned shares. This participation led to laws designed to prevent them from engaging in such activities. Similarly, banks were prohibited from directly owning equity. Such laws, which limit ownership concentration by financial institutions, have contributed to an assumption of passivity on the part of U.S. institutional investor shareholders. Thus, whether U.S. institutional investors, if free to take more concentrated positions in some firms, would in fact do so absent such laws, is an open question.

In contrast, the roles of institutional investors in other countries differ due to differences in their development as well as in the laws that govern their behavior. It has been argued that these laws are the major reason for the differences in evolution between the corporate governance system in the United States and that in other countries (such as Germany or Japan) where, by design, institutions (particularly banks) play a large role in the ownership and monitoring of corporations.
One aspect of the legal framework that has been argued to be important for corporate governance is the protection of the shareholders, particularly minority shareholders (La Porta, Lopez-de-Silanes, Shleifer and Vishny, (1997)). These protections will also have an effect on the ability of a firm to attract outside capital, including institutional investors. Oehl (2000) argues that an important potential force for the improvement of minority shareholder rights in Brazil will come from local institutional investors.

Just as the legal and regulatory environment in the developed markets has helped define the role of institutional investors in corporate governance, so too has the recent development of pension funds and their regulations in Latin America. For example, Glen and Madhavan (1999) argue that the recent development of the Peruvian pension fund system and the governmental constraints that have been placed on the funds’ investments has created a bias towards debt over equity, which influences the relative prices of debt and equity and affects the issuance of both types of securities. The requirements for diversification in domestic institutional investor portfolios that exists in countries such as Peru, will naturally push the institutional investor involvement more toward the U.S. model than the Japanese or German models, thus affecting corporate governance.

D. Interaction between large shareholders and institutional investors

In Latin America, large shareholders and concentration of ownership are important factors in a firm’s governance structure. This can be contrasted with the U.S. where there is substantially more dispersion in share ownership. Majluf, Abarca, Rodriguez, and Fuentes (1998) provide striking evidence of these differences. While the largest shareholders in Chile control 40 percent of the shares of the largest companies, this drops to 22 percent for Germany, 7 percent for Japan and 5 percent for the U.S.

As institutional investment becomes more important in the Latin American countries due to the increasing power of the pension funds, the development of mutual funds, and the increasing investment of foreign institutions, the institutional investors will often be interacting with large private shareholders rather than a diverse group of individual investors. One implication of this process is that although institutional investors will have some influence, the Latin American firms’ corporate governance systems will likely evolve in a different manner than those in the U.S. It
is likely that there will be innovation with new methods of corporate governance developing and that these systems will vary across countries rather than converging to one homogeneous system.

A further question arises from the trade-off between the concentration and dispersion of ownership: the degree of participation in corporate ownership by the diverse types of major equity owners: large blockholders, foreign institutional investors, domestic institutional investors, and employees. How these investors interact will have an effect on corporate governance structure. Thus, important questions develop concerning how these interrelations will affect the Latin American markets. Will the increased presence of institutional investors (whether domestic or foreign) cause corporate ownership in general to become more disperse, changing the corporate governance structure of Latin American firms? Would such dispersion lead to more efficiently managed firms or would the incentive problems of separation between owners and managers become magnified because there was no longer a large blockholder? Since the relative roles of institutional investors and large blockholders are not well understood, this becomes an important issue to consider. Although their roles can overlap, as mentioned previously, there is little evidence that when an institutional investor takes on the role of an activist blockholder, there is a change in the corporation. On the other hand, there is evidence that corporate performance improves after an activist share block purchase. Gorton and Kahl (1999) argue that the two actually serve distinct monitoring roles in which the institutional investor may be permanent blockholders who engage in imperfect monitoring while the large blockholder is able to provide better monitoring, but may be constrained by wealth needs.

Regardless, the implications of the previous research are that the presence of institutional investors, with or without large blockholders, should lead to more informative prices and consequently lower monitoring costs for all investors. Thus, the outcome should be better monitoring of managers and better corporate governance.

IV. CONCLUSIONS

This paper examines the role of institutional investors in financial markets and the governance of corporations. Previous research tells us
that in terms of corporate governance, institutional investors are important in the ownership and trading of corporate equities and debt. In particular, for many countries, institutional investors have become the predominant players in the financial markets. Their ownership and influence worldwide is growing, chiefly due to the widespread privatization and development of pension fund systems. In addition, foreign institutional investors are becoming a significant presence in financial markets, bringing their trading habits and corporate governance preferences to these markets.

Due to the size of their holdings, institutional investors are an important source of monitoring for the agency problems that exist between the shareholders and managers of a corporation. Previous researchers have shown that because of the costs involved, only large shareholders have the incentive to provide extensive monitoring of management. Whether institutional investors as large shareholders should or will provide such monitoring depends in part on their objectives, their constraints and their preferences for liquidity. These characteristics also vary across countries, leading to differences in the involvement of institutional investors in corporate governance practices. As markets are becoming more integrated, however, there is some convergence in the practices and behavior of the institutional investors. Evidence has also found that as foreign institutional investors enter a country, while their trading may differ from that of domestic investors, they do not constitute a threat in terms of the destabilization of the financial markets.

Countries also differ in the existence of large blockholders in their markets, whether in the form of institutional investors, rich individuals, family groups, other corporations or lending institutions. These differences lead to variations in corporate governance practices and the influence of the institutional investors. Which of these groups have significant influence varies across countries, due in part to their legal and regulatory systems and in part to the manner in which the institutional investors have developed. Of particular importance is the interrelation between institutional investors and other factors of corporate governance such as the legal and regulatory system, the market for corporate control, the board of directors, other large blockholders, lenders and employees.

Latin American financial markets have particular characteristics that will likely affect the developing influence of institutional investors on the governance of Latin American corporations. These characteristics include
the relative illiquidity of the markets along with their ownership concentration and the increasing participation of domestic pension funds and foreign investors, either indirectly through American Depositary Receipts (ADRs) or directly. Given these characteristics, we might expect that both the domestic and foreign institutional investors will influence the development of the corporate governance system for Latin American firms. Although there may be some convergence in these systems across countries, because of the endogenous nature of the interrelation between the factors of corporate governance, the evolution will most likely vary across countries. We would expect however that institutional investors will increase the liquidity, volatility and price informativeness of each of these markets. In turn, the increased information provided by institutional trading should result in better monitoring of corporations and in better corporate governance structures.

REFERENCES


CORPORATE GOVERNANCE AND INSTITUTIONAL INVESTORS


Section 3, 15.

Paper.


and CEO Turnover,” Working Paper, University of Texas at Austin.

Control,” *Journal of Applied Corporate Finance* 5, 6-18.


Roe, M., (1990), “Political and Legal Restraints on Ownership and Control of Public Companies,” 


737-775.

13-20.

Analysts Journal* May/June.


ton State University and University of Texas at Austin.

State University.

working paper, Emory University and Purdue University.

Links?” Working Paper, Universidad Católica de Chile.

Law*