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The Role of Investment Companies and Investment-Fund Managers in Exercising Ownership Rights

Introduction

More and more attention is being paid to problems of company management. Our goal was to look at how ownership rights were being exercised by institutional investors. Additionally, we asked questions regarding the activities of institutional investors, focusing on investment companies and investment-fund managers.

In analyzing this area, we used theoretical knowledge and empirical data. We primarily utilized theoretical findings published abroad that analyze situations evolving from the exercise of ownership rights (theoretical issues known from agency theory). In practice, we were interested in the development of policies regarding investors and in the activities of institutional investors in the companies they own.

As for empirical research, we implemented two methods of obtaining data, using two categories of explored subjects. First, we used a survey questionnaire and obtained twenty responses. We consider this a success because investment-fund managers were busy preparing for the second wave of voucher privatization. Interviews were the second method of obtaining information for this work. We interviewed representatives of investment companies and investment funds that were predominantly privately owned.

In the following sections, we examine the situation in Slovakia and the possibilities of applying experience from abroad to the domestic situation. Also, we examine the opinions of participants about the system of corporate governance and present recommendations for improving this system and capital markets in Slovakia. The focus of this work is an analysis of the interests and problems of investment-fund managers, supplemented by policy recommendations.

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Our sample contained twenty investment-fund managers, of which six were managers of large funds, nine were managers of medium-sized funds, and five were managers of small investment funds. The sizes of the funds were assessed by the fund managers.

1. Administration and Management of Corporations as a Theoretical Issue

More attention is being paid to the relationship between owners and managers in order to understand the mechanisms leading to more effective managerial motivation, lower transactions and control cost, and fewer organizational conflicts. These are only some of the multitude of problems appearing in theories dealing with microeconomic and organizational issues. There is not enough space here for a detailed presentation of the findings produced from these theories. We will therefore focus only on the fundamental issues raised in the area of administrative corporate theory.

Agency theory and the theory of transaction costs are the two dominant conceptual approaches used to analyze problems between management and owners and to examine the dilemmas of externalization versus internalization of company activities. Both of these theories prompted deeper explorations, along with some modifications or critical and supplementary approaches, such as the theory of transaction values.

Agency theory explores conflicts evolving between the principals—usually owners and most frequently shareholders—and the agents hired by the owners to perform managerial functions. The theory of transaction costs focuses on operations between companies and explores why certain company activities are eliminated while others are maintained. It is primarily based on a comparison of the costs of a company's activity with the costs that would evolve if the same activity were performed outside the company. In connection with the exploration of the relationship between companies and institutional investors—primarily in cases of the German model of relationships between companies and their owners—the transaction cost theory is used in the form of a contractual governance system.

In summary, corporate governance focuses on minimizing agency costs (the costs of agents), while contractual governance focuses on minimizing transaction costs.

The first type of problem is more relevant to our case in Slovakia, thus we will concentrate on agency theory findings, although not exclusively, because there are different opinions about it.

Also the experiences of statutory boards in corporations abroad are relevant for us in the area of theory, as are general issues connected with the area of corporate governance, including the role of capital markets and institutional investors in this process.

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Discussions about modeling relationships between institutional investors and companies provoke not only disputes about which is more suitable but questions of how active institutional investors are, and want to be, in developed market economies. As the share of institutional owners in corporate properties rises, the sale of large share blocks is increasingly difficult. In some cases, this may lead to efforts to take care of companies existing in the portfolios of these investors. In other cases, investors may tend to avoid company changes and eliminate risks that could lead to an undesired volatility in share prices.

It cannot be said that investors pursue only passive or active strategies, since large privatization funds hire experts with different preferences. Also, there are companies that incur debt to purchase other companies and attempt to manage them. These companies may become another subject in the system of corporate governance. This process is sometimes called "real privatization." According to J.O. Light in his article "The Privatization of Equity" (*Harvard Business Review*, September–October 1989), 5 percent of the market value of publicly owned shares vanished in 1988 because of debt purchases and other privatization transactions.

2. Active Versus Passive Approaches to Companies

The problem of what activities investment-fund managers should perform and how they should behave is a key and frequently discussed issue. The question of whether investment-fund managers should be active (strategic) or passive (portfolio) investors is commonly asked, and our questionnaire provided us a picture that hints at the intended ideas of investment-fund representatives and their future orientation. From our sample, 50 percent of the fund managers intended to focus on an active approach to exercising future ownership rights, such as activities currently performed by almost every fund manager. The second group questioned intended to focus only on portfolio administration and stock trade.

One role of the strategic investor is supporting company development by providing capital. According to some fund managers, a lack of legal possibilities actually to invest in other companies was a major obstacle. Also, some representatives said that they were trying to provide assistance to companies but that insufficient legislation increased the cost of such support.

Other fund managers noted that legislation should classify them as strategic investors or portfolio investors. This classification would enable strategic fund managers to possess higher shares in companies than portfolio fund managers, thus solving the problem of inside-information trading.

Our interest was whether investment-fund managers considered active functioning in companies as being important or whether they preferred portfolio operations. A majority of respondents, 60 percent, said they concentrated on active company management. Of the remaining respondents, 35 percent said

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companies had no preference, and one respondent stated that stock-market trade was dominant.

In the formulation of economic and political regulations related to fund managers, it is important to know whether fund managers intend to concentrate on the control and management of companies. Fund managers responded to this question as follows: 58 percent considered control and company management their permanent role, 32 percent considered control and company management a temporary role, and 10 percent were unsure of the role of control and company management.

The extent to which there is the possibility of exercising ownership rights in a company is an important consideration. An important condition is that owners have enough power and motivation for active control. It is often said that in the case of investment-fund managers, only small property shares and the costs of these activities are unacceptable.

Costs are paid by the investment company, while sometimes even a majority of benefits are received by a majority of other individual investors. There are varying opinions about legislative limitations that should be set regarding the level of an institutional investor's ownership in a company. Some theorists and practitioners quote effective regulations in developed market economies, including the United States, Germany, and France. Some investors in the United States diversify their investments more than is legally allowed. Sometimes when there is an interest in regional investment, investors diversify interests there even when other investors do not diversify their investments so much.

Interview responses proved our assumption that fund managers considered the 20 percent limitation for investment in one company restrictive because it did not allow them to control it effectively. A majority of respondents, 78 percent, considered this a strict limitation. In our survey, we also offered options that took into account the possibility of an amendment to the law that would change the limitations to 25 percent, 30 percent, 35 percent, 40 percent, 50 percent and more, or removing all limitations. The largest group of respondents, 50 percent, advocated the cancellation of the 20 percent limitation. Of those responding, 28 percent suggested raising the limitation to 35 percent.

There are varying opinions about property shareholder limitations, and differences in approaches depend upon investment strategies, including portfolio versus strategic investing, size of funds, and the number of experts on a statutory board. We can say that portfolio fund managers are less interested in an increase in the ceiling on ownership positions that a fund manager is allowed to take in one company. As for the fund size, it can play a certain role in efforts to obtain higher shares of ownership. Managers of large funds have an advantage in this case because they are more able to obtain a higher share in big companies than the managers of small funds. Managers of small funds can do it only in small companies, where their ability to acquire stock would not be determined exclusively by financial resources.

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In some cases fund managers disagree with the proposition that it is possibile to obtain a majority of shares in a company. However, there are those who say it would not have negative effects.* In other cases it is suggested that a majority should be allowed only under the condition that fund managers prove their interest in operating as strategic investors.

In some cases, fund managers say they should have the opportunity to own at least a 20 percent share in the company and believe that the Slovak Ministry of Finance is not positively oriented toward this idea. Investment-fund managers frequently say that a 20 percent limitation is useless, because if a fund manager wants to own a bigger share, it is possible to avoid the restriction. However, it requires more money in the form of transaction costs.

There was also an opinion stating that a strategic investor—a leader—is needed in a company where there are big investors. The opinion of portfolio investors about optimal limitation levels is different, reflecting our previously noted statements. Portfolio investors consider a 20 percent limitation as being too high and believe the optimal level would be between 10 and 15 percent. The highest number of investors advocating this opinion was 10 percent. However, there is also an opinion that if strategic investors own between 3 and 5 percent of a company's shares, it is suitable for sale.

Some proposals argue that legislation should require fund managers to invest their resources in companies and that a law should somehow solve this issue. Here we offer opinions of management regarding this idea. Many representatives agree that if the fund manager is interested in active control, the limitation for ownership should be less restrictive. This could be implemented in two ways:

—through exceptions for some fund managers with the ability to demonstrate an interest in active control and company investment;

—by legally dividing the fund managers into two categories: managers oriented toward portfolio investment, stock-market trading, and utilization of arbitrage opportunities would be placed in the first category; strategic investment-fund managers would be in the second category; the limitation would remain for investors from the first category and would be increased to 40 percent for those from the second category.

The question of active control by fund managers met with varying opinions from company management. It was interesting to look not only at the conflicts among different interest groups but also at the extent to which fund managers felt their power in a company compared to the power of company management. Reactions were as follows:

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*Some fund managers suggest that legislation should make active control possible. This means that fund managers shall be allowed to own between 20 and 100 percent of a company's stock. However, there shall be a regulation stating that fund managers can invest no more than one-third of a fund's property this way. If a fund manager owns more than 40 percent of a company, he will be excluded from the capital markets.

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—in most Slovak companies, the power of investment-fund representatives prevails (6 percent);

—there is a prevalence of fund representatives rather than management (56 percent);

—there is a balance of power between fund representatives and management (25 percent);

—there is a prevalence of managers rather than fund representatives (13 percent);

—in most companies, the power of management prevails (0 percent).

The supervision activities of investment-fund managers and investment companies were also questioned, whether the activity should affect not only the general strategic issues of a company's development but also the operational ones. The responses were as follows:

—only strategic issues (6 percent);

—strategic issues should prevail, but supervision may also affect operational issues (88 percent);

—there should be a balance between strategic and operational issues (6 percent);

—solving operational problems should prevail (0 percent).

In the following order, respondents said the first steps taken by fund managers after they acquired a fund's ownership rights were analyzing all the companies in their portfolios and forming statutory boards, performing economic and financial analyses of the companies in cases where fund managers owned considerable shares of property, introducing management changes, and selling or purchasing additional company shares.

By asking "Is management professional enough to make qualified decisions of strategic importance without the participation of a board?" we can see whether fund managers want to play an active role in companies. Almost two-thirds, 65 percent, responded not in favor of management—that management was not able to make decisions of strategic importance.

The intention of utilizing an active approach in companies was identified in a question about fund managers' plans to gain a significant share of ownership and narrow portfolios in a short period of time.

The issue of how actively fund managers exercise ownership rights was asked in another question related to strategic decisions made by boards. The question was formulated in such a way that the respondents were to assume the entire board's strategic decisions had a value of 100 percent. The respondents were then supposed to determine the portion of decisions initiated by investment-fund representatives and other principals. Based on fourteen responses, the results were as follows:

—decisions were initiated by the managers of the funds questioned (35 percent);

—decisions were initiated by the representatives of other funds (32 percent);

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—decisions were initiated by managers (26 percent);
—decisions were limited by the National Property Fund (5 percent);
—decisions were limited by other owners (2 percent).

These reactions showed that fund managers were very active in influencing strategic issues in the companies.

Recommendation

It is necessary to divide fund managers into the categories of strategic and portfolio investors. Each category should have different conditions for its activities. As for limiting the possible shares of ownership in one company, it should be more liberal in the case of strategic investors. However, it is necessary to modify legislation concerned with inside-information trading.

2.1. Active Approach to Companies and Professional Background

If fund managers are able to execute their ownership rights in companies, it is not enough to have board representatives. They also need experts dealing with organizational problems and problems regarding relevant industries.

The active exercise of ownership rights requires slightly different qualifications than the management of portfolios. Therefore, fund managers interested in active company control must create the necessary professional background. In discussions with fund representatives—usually top management—we discovered that they were aware of this necessity and delegated powers not only to their employees but also to outsiders, such as university professors and professionals in other relevant areas. In some cases, they delegated executive powers to insiders and hired outsiders to work on supervisory boards. Every fund manager uses a different approach in delegating powers to internal and external employees. While one fund manager has 90 percent of internal employees, another has a majority of external employees in statutory positions.

Based on the responses to our survey, figures for the structure of fund management experts were as follows:
—portfolio management experts (40 percent);
—organizational management experts (30 percent);
—industry-oriented experts (27 percent).

We received a different response from managers of large funds, who said the percentage of portfolio specialists was 50 percent, the share of organization management was 24 percent, and industry experts accounted for 26 percent.

Another issue related to qualifications is the amount of time that statutory bodies, primarily boards, dedicate to company activity. This problem is more apparent when the managers of investment funds or companies are delegated to several statutory positions. This is the topic of the following section.

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The problem of whether managers are willing to apply new strategies, including an active approach, to their companies is very complicated. This is the essence of the problem of corporate governance by the institutional investor. Fund administrators sometimes do not have sufficient control over the activities of management because fund managers are not sufficiently under the control of stockholders.

There is also a problem with the experts employed by institutional investors. The activities of investors are considered possible only in the form of general recommendations, not in the form of more specific advice, because some fund managers do not feel competent enough to make recommendations. This problem can be solved by hiring professional managers. Our fund representatives solved the problem of a lack of internal professionals by hiring external specialists, including managers. In one case a fund representative had its own risk-management group working in troubled companies. They revived a certain troubled company, which became profitable. We can see from the responses that fund managers must have a strong base of experts in order to utilize an active strategy.

3. Statutory Bodies: Variety of Models

In order to understand current problems in formulating statutory bodies, some points are presented in the functioning of external supervising directors. Factors that decrease the effectiveness of control and management are the following:

—supervising directors are too busy with their full-time jobs;

—supervising directors are dependent on information from management;

—an absence of knowledge about the company's activities;

—low motivation.

However, external supervising directors are able to assist in protecting stockholders in conflicts with management. This is considered an important contribution. However, external supervising directors are usually appointed to several positions. The tendency to protect the interests of stockholders can therefore be weakened.

The purpose of some statutory board models, including the boards of supervising directors, is explained by the participation of people on whom the company depends, such as representatives of large companies and banks. In his 1972 work "The Size and Structure of Supervisory Boards in Companies: Organization and Its Environment," J. Pfeffer said that "regulation, debt, and size" are the three factors that determine the optimal structure of a supervisory board of directors.

If there is more regulation, there are usually more external directors. The reason is that external people can help influence the regulators of that area, help the organization face regulation, or assist in regulating the activities of the regulators. As for the other two factors we mentioned, they provoke similar

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behavior, though less significantly. The more a company is in debt, the more external experts it employs, which is considered a way of financing debts. Also, large companies employ external experts so that they can influence the public by utilizing various subjects. In all cases, when a company applied these approaches, they obtained higher profits.

There is a common opinion that fund managers cannot supervise companies effectively because they are involved in many statutory functions. Of those answering our questionnaire, 90 percent gave a positive response to the question about whether their fund employees were, on average, represented on more than one board or supervisory board. On average, each representative served on three supervisory boards.

Additionally, we asked whether it is possible to exercise supervision over a company when a fund manager is a member of more than three supervisory boards. A total of 53 percent responded positively, while 47 percent responded negatively. We also tried to find the "break-even" number, from the standpoint of capacity to manage multiple positions. We obtained an average of 3.8, which is more than the actual average of three positions as stated by fund managers.

We were also interested in the circulation of representatives in statutory positions and discovered that circulation is not used strategically; fund managers are often rotated annually onto other boards, and in some cases layoffs occur.

Employing external experts in statutory positions is a general feature of fund managers. According to the interviews we conducted, the average number of positions on statutory boards per one fund manager is three. However, some fund managers stated that they were afraid to reveal higher numbers because this would embarrass the government administration and possibly result in more restrictive regulation in this area.

The question of models of boards of directors and supervisory boards is crucial from the standpoint of power distribution in the company. Opinions about appointing people to statutory positions differ not only among those with different interests, such as the National Property Fund (NPF), investment-fund managers, and company management, but also among large fund managers.

At the current stage of the transformation, we see a variety of corporate statutory board models. This variety reflects different visions of government representation, management, investment companies, and fund representation. The process of designing statutes was initiated by the NPF. Statute types regulating relationships between boards of directors and supervisory boards were also prepared by the NPF along with large fund managers, including members from the Košice-based investment company Cassoviainvest, Harvard Investment Funds, and VUB Invest, the investment company of Slovakia's second largest bank. It seems that there are two basic models in the formation of statutory boards. The NPF suggests a strong supervisory board that appoints the board of directors, which is the management. In this model, the owners (shareholders) are members of the supervisory board. The second model suggests

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a strong board of directors, which is currently the model most often implemented. This model was proposed by investment-fund managers. In companies where there was a prevalence of share ownership by fund managers, board of director positions were occupied by shareholders, a chief executive, and one or two managers, depending on the company's performance. Sometimes the board of directors was made up of managers of large funds, while small fund managers were represented on the supervisory board. In some cases, fund managers moved from the board of directors to the supervisory board.* The strong board made strategic decisions and the supervisory boards played a supervisory role. However, investment companies and fund managers did not have enough people for the statutory positions. Therefore, various hybrids evolved, primarily in companies owned by several fund managers, where each fund manager had a 3 percent share of ownership and there were associations of individual stockholders. It can be said that hybrids do not work well. The worst results can be seen in companies where management seats in the board of directors and the supervisory board have extensive powers.

Empirical research shows that there is no uniform opinion expressed by investment-fund managers and investment companies regarding the ideal model of a statutory board. Opinions differ, with one side advocating that a suitable combination consists of a strong board of directors and a weak supervisory board. This model appears to be preferred by investment-fund managers and companies. Others advocate a model where the board of directors consists of managers and the supervisory boards consist of owners.** The last group prefers neither of the models, and the spectrum of opinions contains every possible arrangement.

Rarely and only on a temporary basis are fund employees members of more than two statutory boards. If so, it is usually arranged in such a way that a fund employee occupies one position on a strong board of directors and a second position on a less important supervisory board.

Case Study: The View of Fund Managers

A fund manager has more than a 10 percent share in about half of the corporations in his portfolio. The fund's management believes that shareholders should be represented on the supervisory board. The supervisory board should have the right to appoint and dismiss the board of directors, and the company's management should be represented on the board of directors.

*This phenomenon can be found not only in Slovakia but also in the Czech Republic. If a company is successful, the investment-fund manager leaves the board of directors and moves to management. Fund managers then take supervisory board positions.

**The board of directors should consist of managers in order to have more responsibility. The owners should belong to the supervisory board. This is the opinion of a fund representative who prefers portfolio management.

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Table 1

Average share in a company when the fund's representative was appointed to a supervisory board or board of directors	Structure of responses
0–2%	0.0%
2–4%	10.5%
4–6%	15.8%
6–8%	15.8%
8–10%	21.2%
10–15%	36.8%
15–20%	0.0%

Table 1 shows responses to a question about the size of a fund manager's ownership share at the time of his appointment.

Recommendation

In order to exercise ownership rights efficiently in the initial phases of transformation, it is appropriate—in the case of strategic investors and potential strategic investors—for the owner to be represented on a board of directors (the model known as the "strong board of directors").

4. Relationships Among Different Representatives in Exercising Ownership Rights

Theoretically, there are conflicts within a company among external and internal interest groups. To understand these conflicts and problems, we tried to discover whether institutional investors discussed their ideas about changes inside the company with interest groups.

Cooperation among different owners and among various interest groups is a basic necessity for efficient company management. The respondents indicated that investment-fund managers and investment companies consulted about their intentions as to company changes. Answers revealed that investment-fund managers consulted with the following groups about their intentions:

—almost 100 percent of the respondents consulted with other investment-fund managers who own company stock;

—80 percent consulted with company management;

—40 percent consulted with employee groups, other owners, and the NPF;

—25 percent consulted with labor unions;

—15 percent consulted with other groups, including professionals, consulting firms, banks, and other important owners.

Cooperation among different interest groups depends upon the will to consult

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their proposals. The average level of cooperative satisfaction was interpreted on a scale of 1 to 6. A rating of 1 indicated high cooperation, a rating of 5 represented poor cooperation, and a rating of 6 meant there was no cooperation. Average results for satisfaction levels were as follows (number in parenthesis represents the answers of large investment funds):

—funds, 1.8 (2.0);

—management, 2.5 (2.7);

—NPF, 4.1 (3.8);

—other institutional owners, 4.3 (5.0);

—unions of individual stockholders, 5.2 (5.5).

Data show that there was no significant difference between total averages and average values from large investment-fund managers, although large investment-fund managers were slightly less satisfied with the degree of cooperation. The position of stockholders' unions formed as direct competitors to investment-fund managers was interesting regardless of who founded them (management, labor unions, or individuals).

Experience indicates that there are some problems with relationships between the NPF and investment-fund managers. There are different opinions about the NPF's work, and there is an opinion that there are permanent changes influencing NPF officials. Simultaneously, investment-fund managers do not know the NPF's intentions. Representatives of some investment funds believe there is no cooperation between them and the NPF.

According to fund representatives, reasons for changing a part of or all management were as follows:

—company's bad economic situation (56 percent);

—management's poor professional skills (26 percent);

—resistance to plans of new owners (11 percent);

—other reasons (7 percent).

One investment-fund manager said that company management was changed by the investment funds in 10 percent of all cases, while in other companies the NPF changed management. Another investment-fund manager stated that members of top management were changed in one-third of the companies. There is also an opinion that there is no improvement in relations between company management and investment-fund managers.

Responses to the question "Should the boards of directors or supervisory board members accept plans of investment-fund managers?" illustrate the situation in the area of mutual cooperation:

—highly favorable, (65 percent);

—favorable, (35 percent);

—no one responded that there was a negative attitude toward the recommendations.

The approach toward potential negotiations with a foreign partner regarding the sale of shares is also an interesting area. This appears to be a very sensitive

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issue that could bring an advantage to one side and losses to the other. The sides in this case are management and fund managers. In some cases management complains that investment-fund managers want to sell shares in a company to a foreign partner. In other cases management complains that investment-fund managers prevented negotiations regarding the entry of foreign capital.

A consensus among different owners is a precondition for the acquisition of real control over the management of companies. This can be achieved through cooperation among investment-fund managers that are represented in statutory positions. An interesting question of "How efficient could it be if there was a dominant investment-fund manager in the company?" arises in this context. Almost two-thirds of the respondents agreed that there were no fundamental problems in decision making when there were several important owners involved, such as investment-fund managers. Only one-third of those responding considered the existence of one major owner—the investment-fund manager—as the best solution that would not cause conflicts. We must say that the idea of one dominant owner is supported by almost all managers of small investment funds. Virtually all managers of large investment funds stated that there were no problems in decision making when there were several important owners in one company.

Our experience from interviews indicates cooperation among managers of large funds (with some exceptions) is better than cooperation among managers of small and large funds. This is probably based on mutual respect among large investment-fund managers, whose representatives meet frequently in boards of several companies. Investment-fund managers are aware that it is important to harmonize their interests and say they are generally able to reach agreements.

5. Obstacles in Exercising Ownership Rights and Regulating Fund Managers

Investment-fund managers face several problems when they attempt to exercise their ownership rights actively. These problems can be serious enough to lead to the managers' removal. According to our questionnaire, the nature of these problems includes:

—deficiencies in the NPF's performance (31 percent);

—insufficient scope of institutional activities on the capital market (29 percent);

—deficiencies in legislation and execution of the Bankruptcy Act (14 percent);

—improper legislation concerning the capital market (11.5 percent);

—activities and structure of organized markets, including the stock exchange (11.5 percent);

—resistance of management (3 percent);

—unclear ownership relations (0 percent).

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As for the participation of investment-fund managers in designing legislation for regulating investment companies and investment funds, the results of our questionnaire showed that approximately one-third of the respondents had initiated or participated in the preparation of the Securities Act and the Act on Investment Funds and Investment Companies. However, only a small portion of the respondents, 17 percent, said that they were satisfied with those laws. The primary deficiencies, as indicated by investment companies, include:

—overly restrictive limitations for investment-fund activities and unreasonable restraints on investor's activities;

—legislative ambiguities;

—strict ownership share limitations for investment-fund managers in one company;

—legal inconsistencies;

—the fact that comments from the Association of Investment Companies and Funds (AISF) were not accepted;

—bureaucracy in the Slovak Ministry of Finance;

—the poor professional skills of the legislation designers.

We must say that a majority of those managing large investment funds, according to our survey, initiated or took part in the preparation of legislation. However, few of them were satisfied with later amendments to the most important laws.

Investment-fund managers complained that they were more regulated than other companies in the Slovak economy. The appointment process of members to investment-fund statutory boards served as an example. Fund managers believed that individual investors were preferred in voucher privatization, and there was an advantage provided to individual investors in bidding procedures.

Recommendations to remove the above obstacles include the following:

• Laws on the activity of institutional investors must be harmonized.

• Standard mechanisms for the protection of minor stockholders must be established. This does not necessarily mean a loss for investment companies and investment funds, but it can increase trust in mutual markets and capital investment.

• It is important to strengthen the position of the Association of Investment Funds and Investment Companies and improve their activities dealing with investment-fund managers, investment companies, and government institutions.

The formulation of new laws and regulations should be based on the following principles:

• The process of changing ownership rights requires a special approach. The possibility for investment-fund managers to hold relatively high ownership shares in one company should be introduced, although this practice is uncommon in developed economies.

• It is important to have an institutional framework that would protect all capital-market participants from undesired practices, thus increasing the

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transparency of the whole system. Examples from the Czech Republic and Spain, with practices of so-called "voucher laundering," illustrate a situation in which the government (or the regulatory office) should assess the impact on the economy and impose preventive measures.

6. The Opinion of Management Regarding the Role of Investment-Fund Managers

Management plays an important role in the privatization process. Managers not only try to buy a company directly or form a joint venture with a foreign partner; they also establish investment funds, initiate the creation of stockholders' unions, and participate in company supervision as a partner with interests that differ from the owners'.

Our survey focused on six companies where the private ownership share (in five of the six) exceeded 50 percent and large investment funds represented the owners.

The results of our survey clearly illustrate differences in management's approach to the behavior of investment-fund managers. We received various answers, ranging from total disappointment with investment-fund managers, through "neutral" responses, to positive assessments. The following case studies document that the surveyed companies differed in individual aspects. At the end of our case studies, we attempt to formulate a general description of managerial approaches toward institutional investors.

Company No. 1

Individual shareholders own 50 percent of the stock in the first company, investment-fund managers own 20 percent, one fund manager owns 10 percent, and the NPF owns almost 20 percent. Private owners control an 80 percent share, and the remaining 20 percent share is under state control. The company has radically downsized, with layoffs of almost 50 percent of its employees in recent years. Various lobbying groups are continually being formed. The board of directors consists of management—including the chairman of the board as the chief executive officer—two investment-fund representatives, one company employee, and one representative of the largest customer. The supervisory board has three members, consisting of one employee and two investment-fund managers. Management thinks that the fund manager wants to sell the company. Proposals of individual stockholders are usually refused because small stockholders are not organized. Management is interested in employee and management joint-stock companies. According to management, fund representatives try to control as much property as possible, with a minimal use of resources. However, management considers the time period after privatization as too short to determine whether the participation of investment funds in the company has had positive or negative effects.

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Company No. 2

The NPF owns 12 percent of the company's stock, investment-fund managers own 60 percent, and individual stockholders own the rest. There are twelve investment-fund managers among the owners of the company, and four of them manage large funds. Initially, fund managers had no idea how this arrangement would work. Corporate statutes were approved on four occasions, and on each occasion there were different results. At the first stage, the board of directors was identical with top management, and the supervisory board consisted of one NPF representative, one employee, and one external member. At the second stage, after the entrance of investment-fund managers, a strong board and a weaker supervisory board of directors was implemented.

Currently positions on the six-member board of directors are decided by four investment-fund representatives and two members of company management. The supervisory board has three members, consisting of an employee, an investment-fund representative, and an independent member.

Ownership share limitations of 20 percent for funds are considered good. If funds were interested in owning more, they should have the opportunity to buy the company directly. Another opinion is that a 20 percent limitation should initially be established and that fund managers with a desire to own a greater share could do so by purchasing more on the stock market.

There are varying degrees of cooperation with investment-fund managers. One of the large fund managers is willing to solve problems. A foreign partner was interested in investing in the company but did not favor the presence of investment-fund managers. In this case the 20 percent limitation had a negative effect.

As for relationships between managers of large investment funds and those of small investment funds, large fund managers attempt to gain more. Small fund managers show little, if any, activity. Some of the fund managers are interested in the economic and financial situation of the company, while others are interested only in the amount of planned dividends. There are distinctions in the way fund managers and foreign investors evaluate the company. Fund managers are interested in the economic and financial situation of a company and are more oriented toward short-term interests. Foreign investors are mainly interested in employees and production potential.

It would be ideal to have large share owners in the company, meaning three shareholders owning 60 percent of a company's stock.

Employees should not have a significant ownership share in the company. A 10 percent share of employee stock is enough to motivate employees, and the stock should be used as part of a reward system. Management should own a portion of the stock—not necessarily a high portion—and the remaining stock should belong to strong owners, such as two investment-fund managers.

Rewards of top management depend on net profits (minus accounts payable and receivable), which is the variable position of wages.

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Company No. 3

The main owners of the third company are managers of four large investment funds. Additionally, there are thirty small investment-fund managers. Since 1990, this company has almost doubled the number of employees, which was unusual for the development of a Slovak company at that time.

Even though the supervisory board had a strong position one year ago (the board of directors consisted of three top management members), it has since been weakened. The board of directors now consists of investment-fund managers and has a strong position. One investment-fund manager wanted to sell the company to a large foreign investor. However, his position in the company weakened subsequently, and the attempted sale failed.

Managers of small funds have no influence on decision making. Some of them own only 5 to 10 shares. As for management motivation, the chairman of the board of directors is the same person as the chief executive officer, and he is the only person with a managerial contract. This contract is valid for one year, and rewards are based on the balance of net profits minus accounts receivable.

Privatization in the form of a management buyout is useless because if management does not gain a 51 percent share of stock it cannot control the company. If management controlled a minority of shares, other stockholders would cooperate against management plans.

In conclusion, cooperation with investment-fund managers is good. Investment-fund managers have a long-term interest in keeping the company's stock and do not trade it. Top management is against the massive trading of the company's stock.

Company No. 4

The management of the fourth company has a negative approach toward voucher privatization. In their opinion, investment-fund managers gained stock free of charge and have only short-term goals. The board of directors is formed by management, and the supervisory board consists of two employees and fund managers. Management was changed before investment-fund representatives assumed their ownership rights. No changes in management are expected because the company is currently profitable.

Company No. 5

Originally, the majority of the shares was owned by individual stockholders and investment-fund managers. However, the ownership structure changed in favor of the NPF thanks to a reevaluation of land owned by the company. Even though the NPF is now the major owner—with a 60 percent share—this case is interesting because the manager of a large investment fund has a strong position in the

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company (owns almost 10 percent). The board of directors is formed by top management, and owners are represented on the supervisory board. The manager of the largest investment fund behaves as the owner in a positive way. This investment-fund manager assisted the company in obtaining a loan and is interested in the efficient functioning of the company. However, investment-fund representatives are aware of the fact that the best possible solution is to delegate all executive power to management professionals.

Company No. 6

The structure of shareholders in the sixth company consists of investment-fund managers controlling 60 percent, individual shareholders controlling 25 percent, and the NPF controlling 15 percent of the stock. There are five investment-fund managers with ownership shares of more than 5 percent. The manager of the largest investment fund controls almost 20 percent, and the second largest investment fund controls more than 10 percent of the stock. Although relations between managers and investment-fund managers are positive and the company is profitable, there have been conflicts of interest. These were caused by a managerial attempt to initiate cooperation with a foreign company, but those efforts were opposed by the investment-fund managers.

The board of directors is formed by management, and the supervisory board consists of investment-fund representatives and employees of the company. The management of the company is opposing an increase of the ownership share of investment-fund managers.

Generally, the opinion of management about the role of investment-fund representatives in the company differs a great deal, ranging from a radical rejection of investment-fund managers to a high degree of satisfaction with their activity. Of course, these opinions reflect both the actual activity of fund representatives as well as the internal struggles for power between investment-fund representatives and management. Past experience is also included in the existing opinions. This applies to situations when management attempts to privatize a company failed and the company ended up in the hands of investment-fund representatives.

7. Empirical Research Summary

Companies

First, we must say that there are different opinions regarding the role of investment-fund managers in companies. In our small sample, we found management satisfied with the investment-fund representatives, as well as those opposed to the active role of investment-fund representatives. If we had to generalize, we would say that there is a certain level of aversion toward investment-fund

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representatives in both successful and less successful companies. A summary of the management opinions is as follows:

—investment-fund managers are not company owners, but they behave—in a negative connotation—as if they were;

—investment-fund managers try to implement their proposals, even when they do not have adequate professional background and experience;

—investment-fund managers try to assist a company in obtaining financial resources;

—investment-fund managers provide existing management with opportunities to develop a strategy and do not influence decision making, which is appreciated by management;

—investment-fund managers do not want to approve management plans to cooperate with a foreign partner or to develop a joint venture.

Investment Funds

There are also different opinions, even among fund managers, about the issues connected with their activities. The most notable difference is observed in fund managers' opinions regarding their future managerial strategies. While one of the fund representatives in the sample is almost exclusively focused on portfolio management, other fund managers attempt to be active owners. However, the fund managers consider their active approach in some cases as only a temporary phenomenon.

We were interested in three areas regarding the policies of investment-fund managers:

—active versus passive investors;

—investment-fund regulation;

—investment-fund managers operating in statutory positions.

The average number of positions held on statutory boards was three, as asked in one of our questions. We repeat that fund managers were afraid to state higher numbers because of the possibilities of new regulations in this area. From the responses of many investment-fund managers, it appears that the number of persons on statutory bodies is higher than they said. We do not consider the number of positions to be a fundamental issue for the activities of investment-fund managers. The operational effectiveness of investment-fund representatives depends on the ability of investment-fund managers to assess accurately the capabilities of each employee handling the tasks of their representation in companies.

Conclusion

Finally, we would like to stress the importance of the interaction between capital-market developments and issues regarding integration with the European

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Union (EU). If Slovakia is interested in entering the EU, emphasis must be placed on harmonizing legislation and searching for internationally accepted arguments to analyze the specific features of the transformation of the national economy.

Investment companies and investment-fund managers are exposed not only to the attention of the supervisory authorities but also to that of political parties. The exposure of large investors to strong political pressure from the national government, local authorities, and various other interest groups is not a new element. Economic development requires that large investors be treated as important subjects in our economy and our capital market. The acceptance of the economic powers of institutional investors requires proper behavior toward their stockholders and the acceptance of the principles of "fair play" in their own associations, including the Association of Investment Companies and Funds. Independent supervision of the capital market is necessary, in order to create a competitive environment and eliminate tendencies to misuse information or practices leading to tax fraud. At the same time, the development of capital markets and institutional investors is important as well because their activities can lead to economic growth and efficient resource allocation.

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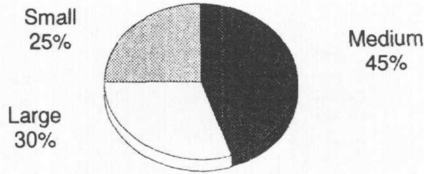
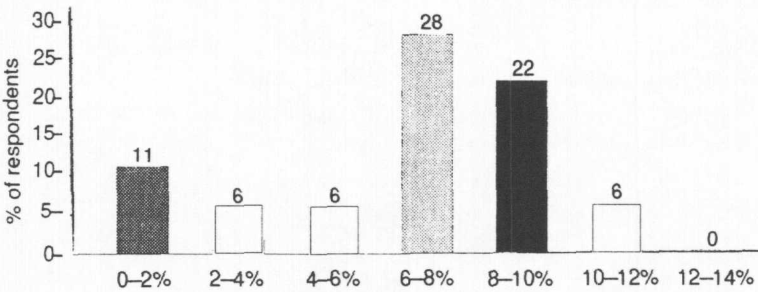
Appendix

Statistical Evaluation of Survey on Investment Funds and Investment Companies

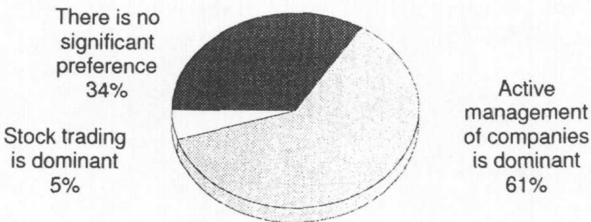
1. Structure of respondents (investment funds and investment companies) according to their size:



2. Average ownership share of companies in your portfolio is:



3. Do you focus your attention on active functioning in companies aimed to improve their economic results and thus the market price of stock, or do you prefer optimization of your portfolio through stock trading?



4. In your opinion, is a 20 percent investment limit in one company large enough for efficient control of a company's operations?

22% YES **78% NO**

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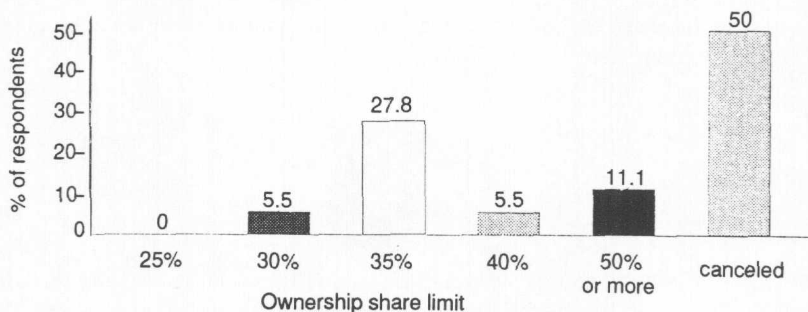
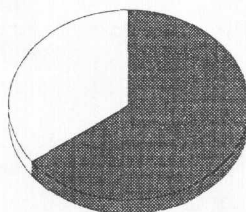
5. If your answer to Question 4 is "no," do you think that the limit of a fund manager's ownership share—currently at 20 percent—should be increased to 25 percent, 30 percent, 35 percent, 40 percent, or 50 percent or more, or should the limit be canceled?



6. What is your opinion about the impact of the ownership structure on decision making in the company?

A. One dominant fund manager is the optimal solution because operating with several investment-fund managers leads to conflicts.

B. There are no fundamental problems in decision making when there are several investment-fund managers with high ownership shares.



7a. Have you initiated or participated in the preparation of the Securities Act and the Act on Investment Companies and Investment Funds?

35% YES **65% NO**

7b. Are you satisfied with those laws?

17% YES **83% NO**

8. Do you seek consultation regarding your intentions as to changes in the company?

100% YES

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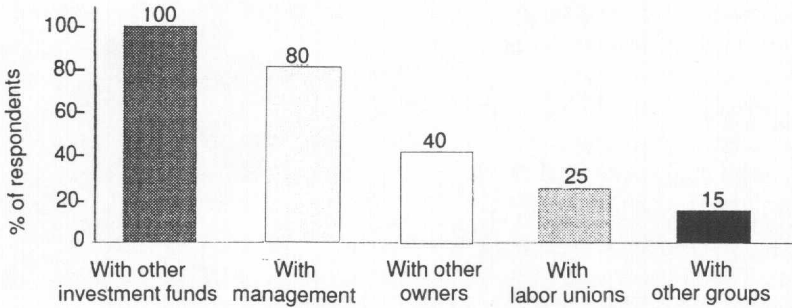
Consultations with particular groups:

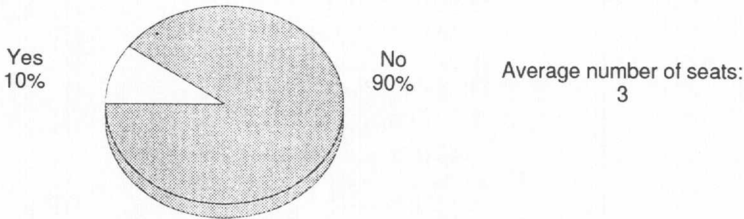


9. How do you cooperate with other groups in exercising ownership rights in your portfolio's companies? List according to the degree of your satisfaction with the cooperation (scale: 1 = very high, 5 = very low).

Satisfaction with Cooperation—Ordered List

	Interest group	Average value
1.	With other investment funds	1.8
2.	With management	2.5
3.	With NPF	4.1
4.	With other institutional owners	4.3
5.	With Union of Individual Stockholders	5.2

10. Do the representatives of your investment fund sit on the boards of several companies?



11. Do you think that fund managers' activities should be exclusively focused on general issues, such as strategic decisions, or should they also cover operational issues?

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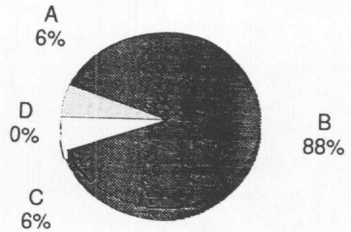
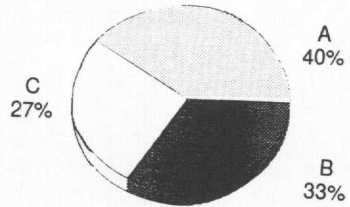
A. only general issues (strategic decisions);
B. strategic decisions should prevail, but it shall also affect operational questions;
C. strategic decisions are as important as operational problems;
D. solving of operational problems should prevail.



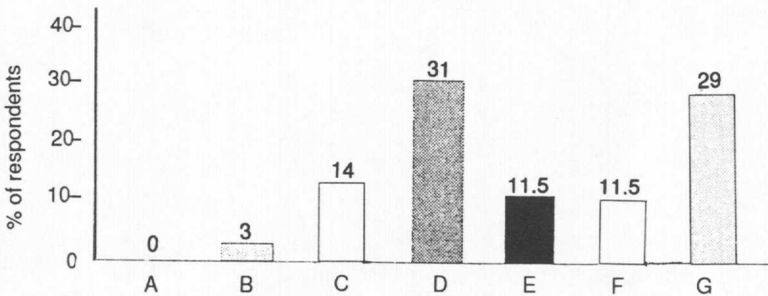
12. What is the structure of the experts in your fund?

A. portfolio management experts;
B. organization management experts;
C. experts with industry orientation.



13. The greatest obstacles to exercising ownership rights are:

A. unsolved property rights;
B. resistance of management;
C. deficiencies in legislation and execution of the Bankruptcy Act;
D. deficiencies in the NPF's performance;
E. improper legislation concerning the capital market;
F. activities and structure of organized markets, such as exchanges;
G. insufficient scope of activities by capital-market institutions such as the Slovak Securities Center and the Slovak Ministry of Finance.



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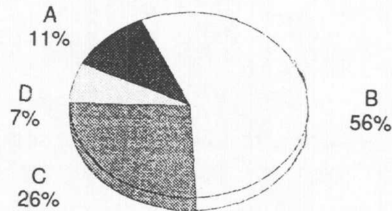
14. What were the first steps your fund managers took after acquiring ownership rights (list in order from 1 to 6)?

Range	Step	Average value
1.	Establishing supervisory boards and boards of directors	1.82
2.	Analyze all companies in portfolio	1.82
3.	Financial and economic analysis of companies where fund managers own considerable shares	2.35
4.	Initiation of management changes	3.64
5.	Sale of your shares	4.29
6.	Purchase of additional shares	4.35

15. Reasons for changing all or part of company management include:

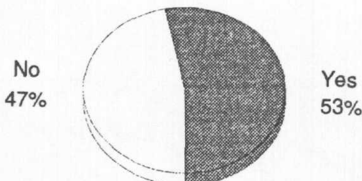
A. resistance to plans of new owners;
B. bad economic situation of company;
C. poor professional skills;
D. other reasons.



16. Is management professional enough to make qualified decisions of strategic importance even without the participation of a supervisory board?

35% YES **65% NO**

17. In your opinion, is it possible to supervise a company professionally when the representative of a fund is a member of more than three boards or supervisory boards?



What is the "break-even" number from the standpoint of capability of managing more positions?

The average optimal number of position:
3.84

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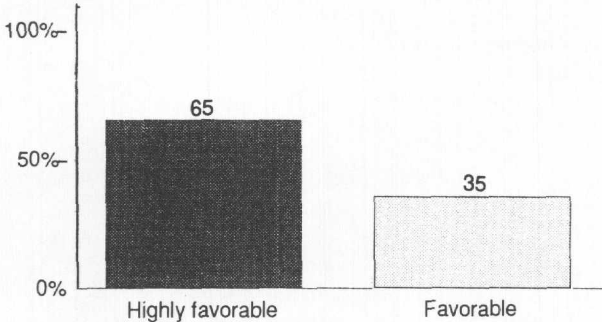
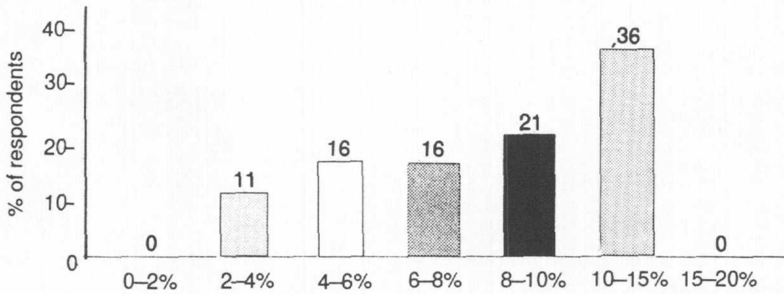
18. Are you going to narrow down your portfolio in the near future to gain significant ownership shares allowing you to control companies more actively?

79% YES **21% NO**

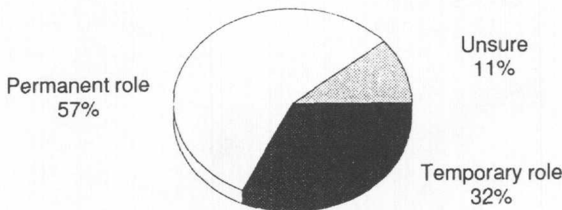
19. Do members of a supervisory board or boards of directors accept the comments of your representatives?



20. What was the average ownership share that allowed you to appoint a representative to the board of directors or supervisory board of the company?



21. Do you consider managing and supervising companies as a temporary or a permanent role of your fund manager?



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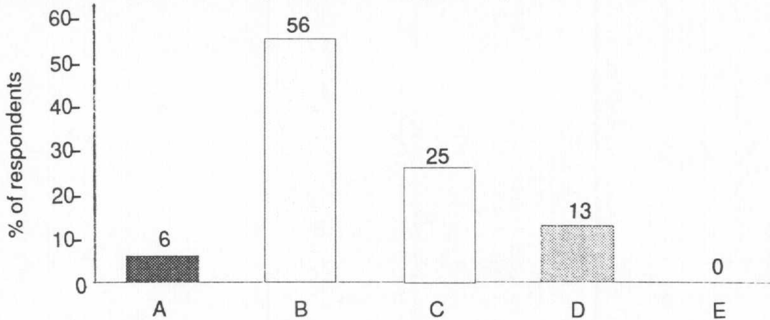
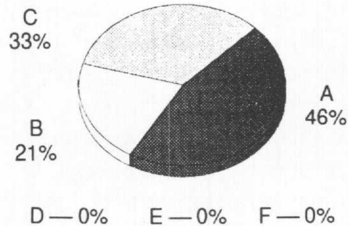
22. In your opinion, does the decision-making power of investment-fund managers prevail over the power of company management?

A. The power of investment-fund managers prevails in most Slovak companies.
B. There is a prevalence of fund managers rather than management.
C. There is a balance of power.
D. There is a prevalence of company management rather than fund managers.
E. In most companies the power of management prevails.

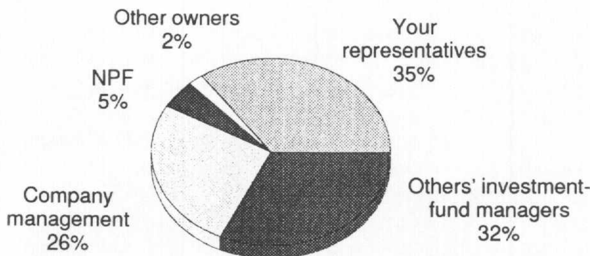


23. What are your short-term (one-year) plans?

A. increase ownership shares in selected companies in order to gain active control;
B. portfolio diversification;
C. participation in the second wave of coupon privatization;
D. sale of all assets;
E. liquidation of investment funds;
F. others.



24. If we assume that the total number of a board's strategic decisions is 100 percent, please determine the portion of decisions initiated by various ownership groups:



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