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Towards an Indirect Agency Theory

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Abstract
Forty years after development of the original agency theory by Jensen and Mecklin, firms have evolved and created convoluted structures in order to subsist the turbulent environment that the business world has become. Consequently, the 21st Century has seen emergence of corporates with webs of direct and indirect interests in form of ownership and other interests. This paper reviews the original agency theory, its consequent developments and the extent to which it applies to firms with indirect ownership. I use the case of collective investment schemes to demonstrate that the agency theory in its initial postulations explicates the agency problems in firms with direct ownership but fails to explain the agency intricacies in firms with indirect ownership and interests. As such I propose an indirect agency theory that provokes thought on the problems, entitlements and reactions of indirect stakeholders to corporate governance lapses.

1.0 Introduction

Key developments in the 21st Century include unprecedented growth in institutional investors. Key amongst these institutional investors are collective investment schemes such as mutual funds, unit trusts and insurance companies amongst others. These institutions pool funds from individual investors and small firms and invest on their behalf. The original investors therefore have indirect interests in the investment vehicles that the collective investment schemes choose to invest in.

Institutional investors were reported to own 70% of the equity of U.S corporations (Gaspar, Massa, Matos, Patgiri, & Rehman, 2013) and over 50% of the equity of European companies (Brossard, Lavigne & Sakinc, 2013). Willis Towers Watson (2016) conducted a study on 19 major pension markets and estimated the values of the assets at USD 35316 billion at the close of 2015 representing an average of 80% of the GDP of the countries – with Australia, Netherlands, Switzerland, UK and US recording pension asset values in excess of 100% of their GDP. The study further names the largest pension markets as US, UK and Japan with 61.5%, 9% and 7.7% of the total pension assets. Of the total pension assets, Willis, Towers and Watson show that 44% were held in equities, 29% in bonds and 24% in other assets. In Africa, South Africa led the pack in 2015 with pension assets amounting to USD 181 billion (Willis Towers Watson, 2016). Ashiagbor and Vidal (2016) estimate the pension assets in other African countries to be worth USD 25.8 billion in Nigeria, USD 8.1 billion in Kenya, USD 7.8 billion in Namibia, and USD 5.6 billion in Botswana. The Investment Company Institute places the value of total worldwide assets invested in regulated open end funds at $37.2 trillion at the end of 2015. In the US, the investment companies' total net assets amounted to $18.1 trillion held in mutual funds ($15.7 trillion), exchange traded funds ($2.1 trillion), closed end funds ($261 billion) and unit investment trusts ($94 billion). Further expansion of the industry has led to the development of cross-border mutual funds. Consequently, there is need for advancement of mechanisms to protect investors who put their funds in the collective investment schemes.

In the last four decades, agency theory has been predominantly used to explain relationships between management and ownership and has been used as the bedrock for the development and application of corporate governance principles (Mamun, Yasser & Rahman, 2013). This has been exemplified in large firms with disaggregated ownership that require a higher level of monitoring of managers as they have greater space to take excessive risks at the expense of the shareholders.

The popularity of collective investment schemes amongst individuals and small firms lies in their ability to harness economies of scale, diversify risk, reduce transaction costs, conduct research and make informed investment decisions. However the collective investment schemes limit the choices that investors can make with regard to investment vehicles and the loss of investor's rights in the corporates.[1]

Berle and Means (1932) document that as long as there is separation of ownership and control the industry becomes consolidated and hence reduces oversight checks on abuse of power. Such is the case in the financial services industry in most countries that are dominated by few firms mostly precipitated and executed through mergers and acquisitions. For instance, Deloitte (2016) document that merger and acquisition deals valued at £265.1 billion were reported by the end of the third quarter of 2015 in the financial services industry. The author documents three trends in the industry namely; market disruption and technology, size and regulatory

[1] Investors in collective investment schemes lose the right to attend annual general meetings and vote as their funds are invested through the collective investment scheme.

changes.

In essence, collective investment schemes have many agency and contractual relationships, key amongst them being the relationship between them and the companies in which they invest in. The fact that the collective investment schemes invest the overall wealth in many diversified companies to minimize risk complicates their monitoring role of the decisions that corporates take. This situation exposes the investors in the collective investment schemes who in many cases have incomplete information and small stakes that make active monitoring inefficient. Khismatullin and Kharisova (2014) argue that the financial crises in the 21st Century exposes the weaknesses of the market for collective investment. As a result, corporate failures such as Enron, WorldCom and Marconi have led to reduced trust amongst the shareholders (Mir & Seboui, 2008). With collapse of such companies, indirect shareholders are always at a loss as they do not have priority ranking during bankruptcy.

This paper proposes an indirect agency theory that can explain the reactions of and rights of investors in collective investment schemes. I develop the theory in phases where section 2.1 provide in-depth analysis of the inventive agency theory, section 2.2 explains other theories that are woven around the classical agency theory. In section 3, I evaluate the application of the classical agency theory and other theories discussed in section 2.2 to collective investment schemes and unearth the limitations that these theories have in explaining the circumstances that indirect investors face. In section 4, I argue the case for an indirect agency theory to explain the position of indirect investors. In section 5, I make conclusions and propose areas where empirical data can be applied to test application of the indirect agency theory.

2.0 Literature Review

2.1 Original Agency Theory

Adam Smith developed the original theory of the firm in 1776 arguing that inclusion of more than one individuals in the control of a firm causes suboptimal results to the owners as the objectives are diluted rather than achieved idyllically. Later, Berle and Means (1932) introduced the discussion on separation of management and ownership. Picking up the discussion, Jensen and Meckling (1976) developed the classical agency theory that view managers as agents of the shareholders, who driven by the motive to maximize their interests fail to act in the best of the interests of the shareholders.

From the agency theory perspective, contractual relationships between principals and agents become critical in the prevention of excesses by the agents, consequently principals must provide incentives or bond agents and bear the residual losses in order to minimize value decreasing decisions taken by the managers on behalf of the firm. Jensen and Meckling (1976) thus conceptualized agency costs that principals must incur to safeguard their interests as monitoring costs (auditing and performance measurement), bonding costs (profit share with managers) and residual losses (residual costs of recruiting managers and dilution).

Agency problems arise when information is obscured from the principals by the agents, agents pursue personal interests at the expense of the principals, agents set goals that contradict the corporate objectives and take excessive risk that is often borne by the principals (Jensen & Meckling, 1976; Fama & Jensen, 1983).

2.2 Other Theories

2.2.1 Stewardship theory

The *steward theory* is rooted in psychology and sociology and was developed by Donaldson and Davis in 1991. It portrays managers as ethical curators who will maximize the returns of a firm in good faith and without self-seeking. The theory contrasts the agency theory by postulating that managers are superb stewards who, given an opportunity will act to the best of the interests of the firm and will align their interests with those of the firm (Donaldon & Davis, 1991; Block, 1996; Peggy & Hugh, 1997) hence no conflicts exist between managers and owners. While the theory fails to advance the motivation that such managers would have to achieve organizational objectives, Smallman (2004) suggest that the benefits will be consequent to the achievement of organizational success as a result of organizational and individual goal convergence. Achievement of the firm's objectives results to satisfaction of the stakeholders (Davis, Schoorman & Donaldson, 1997) in a context where there is balance of powers in the leadership of the board. Applied to agency, stewardship theory provides for the separation of powers, internal checks and the concept of CEO duality since according to Caldwell and Karri (2005) there are conventional duties that managers owe to the stakeholders. Stewardship thus places the long term interests of the firm ahead of the self-interests of the managers hence ignoring individualism consequently aligning their personal objectives with those of the firm (Donaldson & Davis, 1991). To succeed through the theory principals must trust agents, refrain from exercising undue influence on them and hire competent and honest managers. Trust, open communication, managerial empowerment, long-term orientation and performance enhancement are the critical pillars which support stewardship (Davis *et al,* 1997).

2.2.2 Stakeholder theory

The *stakeholder theory* is based on the notion that a corporate entity exists to serve its broad range of stakeholders who are primarily the shareholders (Abrams, 1951) granted that the firm impacts on parties who are external to it either directly or indirectly (McDonald & Puxty, 1979; Freeman, 1984; Clarkson, 1995; Sundaram & Inkpen, 2004). Firms therefore have an obligation to identify the stakeholders (whether contextual or contractual) and their specific needs (Lashgari, 2004; Coleman, Hacking, Stover, Fisher-Yoshida & Nowak, 2008) and develop policies to address these concerns. Agency from this perspective is the framework that ensures that the often conflicting interests of the stakeholders who have delegated their duties to managers are addressed in a fair manner by the firm, principally because managers have resources and capability to deal with the company's internal governance delinquencies (Hosmer, 1996; Freeman, 2004).

The primary role of the managers under the theory is to create value for shareholders since they have a legitimate claim on the firm's assets. Etzioni (1998) documents that this right should be extended to other stakeholders namely; employees, community, lenders, industry and government amongst others. Goodpaster (1991) agrees with the view but observe that the ethical duty that managers have to the shareholders differs with the one they have to the other stakeholders and boldly states that they only owe fiduciary duty to the shareholders.

2.2.3 Resource dependency theory

The main tenet of the *resource dependency* theory is the environmental linkages existing between the firm and external resources (Pfeffer & Salancik, 1978) that are important for the firm's survival (Daily, Dalton & Canella, 2003). The theory places the responsibility of raising corporate resources (finance, information, skills and critical networks) on the directors (Hillman, Canella & Paetzold, 2000; Rodriguez, Ricart & Sanchez, 2000) and therefore requires them to be astute and provide their own specialized expertise in the management of corporate affairs with a view of reducing transaction costs associated with hiring these resources from external providers (Abdulla & Valentine, 2009). The resource dependency view supplements the agency view by focusing on the need for a board of directors with diversified skills, appointment of independent directors and continuous training of the board.

2.2.4 Political theory

The *political theory* derives its postulate from exercising influence through voting (Pound, 1993). Corporates have long history of control by ownership through shares hence corporate decisions are influenced by the majority determined by the ownership structure. The political theory determines who will serve in the board, powers and privileges that the board will have and the consequent strategic direction that the firm will take. The political theory therefore contributes directly to corporate governance practices of the firm (Abdulla & Valentine, 2009). Lashgari (2004) suggests that shareholder activism, that is a reaction to agency problems, derives its legitimacy from the political theory as the level of activism depends on the decisions taken by the board that is appointed through the political process.

2.2.5 Virtual ethics theory

The *virtual ethics* theory is about "moral excellence, goodness, chastity and good character" (Abdulla & Valentine, 2009, pp. 93) that is a matter of individual choices, which according to Aristotle comes from theoretical and practical knowledge. Accordingly, virtue ethics are multi-track personalities that influence emotional reactions, choices, values, desires and perceptions (Hursthouse, 2013). Proponents of the theory argue that positive feelings are a function of doing the right things and are exhibited by individuals. Bowden (2005) however argue against the theory insisting that it is built on a "false base", does not result to fulfillment and is not an answer when making complex moral decisions. In the context of agency, virtual ethics may inform the need for an educated and experienced board and the desire to conduct proper and fit tests (tests of character, competence and capability) before appointment in to the board to minimize the agency problem.

2.2.6 Discourse theory

On its part, the *discourse theory* of ethics focuses on establishment of the right, moral and political principles emerging from certain ideal conditions (Jones, 1997). It emphasizes on conflict resolution through communication where parties are deemed to be equals, absence of coercion in dispute resolution, rationality in argument in addition to open ended communication (Harbemas, 1990). Discourse theory complements agency in two ways *firstly;* two-way communication with stakeholders is viewed and is widely accepted as a key tenet of corporate governance and *secondly;* agency focuses on resolution of potential conflicts that inherently arise between managers and the shareholders.

3.0 Application of the Agency and other Theories to Collective Investment Schemes

Starting from the classical studies by Fama (1980), Fama and Jensen (1983), Jensen (1983) and Jensen (1986), a number of other studies have authenticated application of the agency theory in different milieus, for instance, Chetty and Saez (2007) use its propositions to develop a model for the efficiency cost of dividend taxation; Krueger (1991) and Kehoe (1996) used it to analyze franchising in the fast foods industry and US hotel industry respectively; Amihud and Lev (1981), Denis, Denis and Sarin (1997, 1999); Amihud and Lev (1999); Ramaswany, Li and Veliyath (2002) and Elyasini and Jia (2010) used the theory to test the effect of equity ownership structure on corporate diversification strategies. Lane, Canella and Lubatkin (1998; 1999); Aggarwal and Samwick (2003) tested the effect of agency on diversification. Additionally, Barnhart and Rosenstein (1999) used it to reflect the relationship between board composition, managerial ownership and firm performance. Krishna and Loch (2005) used it to analyze technology strategy in new product development.

Despite its validation, most of the empirical studies conclude that without close monitoring by shareholders, managers adopt self-seeking behaviour and make value destroying decisions (Denis *et al*, 1997, 1999; Ramaswamy *et al*, 2002). Moreover, the changes in business environment and the presence of self-seeking managers forces shareholders and regulators to develop ethical responsibility, codes of conduct to control behaviour of managers and managerial incentives following the stipulations of the agency theory (Mumin *et al,* 2013). It however does not cover all aspects of corporate governance (Mumin *et al,* 2013).

Although the prominence of monitoring in the contractual agency relationship is underscored by Jensen and Meckling (1976), they fail to detail the process of efficient monitoring for a firm as they do not provide an explanation of how firms structure themselves to take charge of the agency problem. Additionally, Fama (1980) postulates that the discipline of the market combined with internal and externa influences will dictate managerial reactions.

What complicates indirect agency in the context of collective investment schemes? Jensen and Murphy (1990) were of the view that to mitigate the principal-agent conflict, ownership structure must be concentrated and the firm must set up outcome based incentives. The inherent design of collective investment schemes is such that the two conditions cannot be fulfilled since most of the investors in these schemes are disaggregated and hold a paltry stake and are not able to influence development of performance based remuneration. The monitoring of directors by shareholders is accentuated where the shareholders hold large proportion of equity (Amihud & Lev, 1981; Denis *et al,* 1999), which is not the case with collective investment schemes.

As a result, special agency problems arise in the case of investment in collective investment schemes or pooled funds. It is expected that unit holders in a collective investment scheme will delegate the duty to invest and monitor to the managers of the collective investment schemes. Consistent with the agency theory and the arguments in Fama and Jensen (1983); Boyd (1995) and Ahmed (2008), managers of collective investment schemes and those of the corporates that they invest in may be self-seeking, have little or no interest in outcome of decisions they make and hence invest in value decreasing activities. The decrease in value of the corporate will be borne by the investors in the collective investment schemes who have an indirect stake in the corporate that they did not *prima facie* participate in the decision to invest in. This aspect is complicated by the fact that the traditional choices of voice, loyalty and exit – towards the corporate are not options to the investor in the collective investment scheme. In other words, the indirect investor cannot influence how the corporate in which the collective investment scheme is holding a stake will be exercised. This calls for an in depth scrutiny and development of a theory to explain the agency problems in an indirect investment relationship and the mechanisms that indirect investors can use to minimize their exposure to corporate risks as indirect investors do not have a way of disciplining corporate managers of firms that their wealth is indirectly invested in.

The postulates of trust, open communication, managerial empowerment, long-term orientation and performance enhancement expounded by Davis *et al* (1997) in the stewardship theory fail to apply to indirect investors as they are not provided with information relating to the performance of the investment vehicles in which collective investment schemes have invested on their behalf. Even if the information was provided, indirect investors would still be at a loss as they are not prima facie investors in those firms.

Theoretically, the interests of indirect investors are taken care of by the stakeholder's theory in view of Etzioni (1998) definition of stakeholders. Since managers only have a primary duty to the immediate shareholders according to Goodpaster (1991), the indirect shareholders lose out. Even if corporates took care of collective investment schemes as their primary shareholders, there is no guarantee that the benefits obtained thereupon will be transferred to the investors in the schemes. Resource dependency too does not seem to create demand for the disaggregated resources held by micro and retail investors.

The political theory further fails to position indirect investors as they lack the defense mechanisms of voice and exit. Their voices are so dispersed that meaningful changes in the corporate affairs and collective investment schemes would really not be achieved. Additionally, they are tied to punitive contracts that make exit suboptimal. Lastly, the virtue ethics and discourse theories are only voluntarily applied as there are no mechanisms to compel managers to act in the best of interests of the direct and indirect shareholders.

4.0 Indirect Agency Theory

Figure 1 conceptualizes the indirect relationship that investors in a collective investment scheme have in a corporate body in which the managers of the collective investment scheme choses to invest in. It depicts investors in a collective investment scheme as vulnerable stakeholders whose returns depend on the net returns generated by the collective investment schemes in a context of agency problems.

Collective investment schemes have direct shareholders who form them to make profits defined as the excess of returns generated from the investment vehicles they invest in less administrative costs and returns paid to the unit investors.

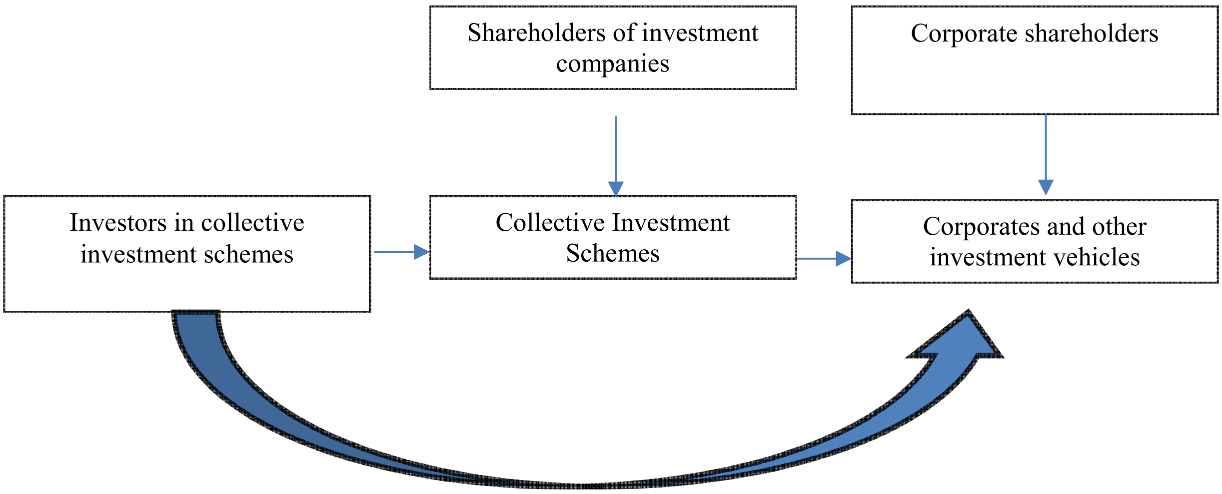

Figure 1: Conceptualization of the Indirect Agency Theory

The *investors in the collective investment schemes* will typically be retail or small firms interested in maximizing returns in a context where they have little expertise on investment matters and financial market dynamics and may also be facing capital constraints such that a direct investment in the corporates and other investment vehicles becomes inefficient. Typically, these will be investors in a pension fund or unit holders in a mutual fund or a unit trust.

The *collective investment scheme* is typically be a pension fund, insurance company or an investment management company that typically calls upon investors to accumulate their funds for collective investment in order to take advantage of economies of scale, diversify risk and consequently generate greater returns. The corporates and other investment vehicles will be the corporates and governments that are deficit agents who seek to raise equity and debt from the financial markets to bridge their funding gaps.

Conventionally, it is expected that collective investment schemes will be better corporate monitoring agents than individual investors as they are more informed and have relatively bigger "collective" stake in the corporates, which would lead to better performance (Shleifer & Vishny, 1986). Bogle (2010) shows a different picture in the U.S where the schemes failed to control executive remuneration. In other instances they have been found to invest in companies with perceived better governance to avoid monitoring costs (Chung & Zang, 2011) consequently using a "hands off" approach.

The returns on investment for the indirect investors depend on the value increasing decisions taken by the managers of the collective investment schemes and the corporates that the collective investment schemes invest in, making them stakeholders if the definitions of a stakeholder stated in Freeman (1984); Freeman (2004) and Friedman & Miles (2006) hold.

The proposed indirect agency theory postulates that the investors in collective investment schemes face unique agency problems with regard to the corporates and other investment vehicles that the managers of their collective investment schemes seek to invest in (lend to). In the event that these corporates and governments undertake value decreasing activities, the investors in collective investment schemes lose out and do not have direct rights to these corporates as they are "strangers" to the investment contract. Following this thinking a few questions emerge namely; what are the rights of investors in a collective investment scheme? How can investors in a collective investment scheme protect themselves from corporate scandals in the corporates and other investment vehicles that their collective investment schemes have invested in? Are there market mechanisms that can protect these investors? Theoretical answers to these questions are included in sections 4.1, 4.2 and 4.3 respectively.

4.1 Rights of Investors in a Collective Investment Scheme

Granted that indirect investors are direct stakeholders in a collective investment scheme and indirect stakeholders in the corporates in which the collective investment schemes put their capital and following Craig (2010) assertions, they are entitled to information on the corporates where the collective investment schemes have put their funds. The transparency in provision of information would help to increase expected returns (Gray, Owens & Adams, 1996). Three common problems would however arise; *firstly,* it is not clear what information would be useful to the investors (Craig, 2010) *secondly* most of the investors would not be able to effectively use this information to inform future decisions due to limited analytical ability and previous contracts that could forbid or severely penalize exit for instance in a life insurance contract or investment in a unit trust and *lastly* the information provided could be false and thus mislead the decisions that the investors make. It could appear prudent to enforce the following rights for the investor; to receive unit certificates within a reasonable time and be supplied with information on investment policies and objectives of the collective investment scheme.

4.2 Indirect investors' self-protection mechanisms

From the foregoing, it is apparent that an indirect shareholder have little or no remedies against a poorly managed corporate in which the collective investment scheme has invested their funds as the voice and exit options are not optimal solutions. The only remedy would be to sue the trustees of the collective investment schemes, in negligence. This would typically require the investor to prove the breach of the duty of care – a difficult proposition to demonstrate in a market with incomplete information. Additionally, indirect investors would need to get training on investment matters, actively seek information and lobby for regulatory enactment and enforcement.

4.3 Market mechanisms for protection of indirect investors

It appears that regulation can result to better protection of the indirect investors. Regulation is however only useful in the management of non-market risks (Khismatullin & Kharisova, 2014). Regulation should also establish a procedure for compensation in bankruptcy and protect the investors against false information supplied by the corporates. Additionally, audit of financial statements and risk disclosures should be made mandatory because of the high public importance. Lastly, Khismatullin and Kharisova (2014) propose insurance, which if necessary will make compensation to the losers.

5.0 Conclusions and suggestions for further research

This paper has provided theoretical backing of the classical agency theory and the nexus it has with other related theories. The arguments expounded lead to the conclusion that the classical theories provide explanations for managerial and shareholder behaviour where direct investment in a corporate exist. Investors in a collective investment scheme are broadly left exposed yet they are indirect investors in the eventual corporates where their funds are invested. The development of an indirect agency theory would stimulate thinking on strategies that can be adopted to maximize the welfare of the indirect investors. Financial market regulation should develop towards protection of these investors who are increasing by the day in an intricate financial world.

The arguments provided in this paper are not backed by empirical data. It would therefore be prudent to subject the assertions of the indirect agency theory to empirical research. Further research should collect empirical data on the regulatory measures implemented to protect these investors from the regulator's perspective. Additional empirical research should focus on the investors to establish the self-protection mechanisms that they have put in place.

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