Disincentives to Activism by Institutional Investors in Listed Australian Companies[†]

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1. *Introduction*

A. *Context*

Several British and American commentators, who have advocated a greater level of monitoring of corporate managements by institutional shareholders, rely upon "mere exhortation"[1] as a means to achieve that end. For example, Sykes proposes a "radical compact" between institutional shareholders and the managements of large listed UK companies, involving the negotiation of five to seven year performance targets (to which salary would be linked) for executive directors, and the appointment of institutional nominees as non-executive directors, but envisages "no need for legislation to force the new system to come to pass".[2] Gilson and Kraakman set out a slightly different scheme under which US institutions — especially those which "index"[3] their equity investments — could elect professional non-executive directors to a minority of positions on the boards of quoted US companies.[4] Gilson and Kraakman state that their agenda does not require regulatory reform: "[i]nstitutional investors must merely decide to act".[5] They then note that they cannot think of a reason why US institutions have not already begun to implement a scheme similar to their proposal.[6] However, as Coffee says, "[t]he problem is

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1 Terminology of Davies, P L, "Institutional Investors in the United Kingdom" in Prentice, D D and Holland, P R J (eds), *Contemporary Issues in Corporate Governance* (1993) at 90.

2 See Sykes, A, "Proposals for a Reformed System of Corporate Governance to Achieve Internationally Competitive Long-Term Performance" in Dimsdale, N H and Prevezer, M (eds), *Capital Markets and Corporate Governance* (1994) at 111.

3 See discussion in Part 3 Section E below.

4 Gilson, R J and Kraakman, R, "Reinventing the Outside Director: An Agenda for Institutional Investors" (1991) 43 *Stanford LR* 863.

5 Id at 905.

6 Ibid.

not with what Professors Gilson and Kraakman say, but with what they leave out".[7] The same could be said in regard to the proposal of Sykes. There are many factors which act as disincentives to detailed monitoring by institutional shareholders. These disincentives almost certainly explain why the proposals of Sykes and Gilson and Kraakman are just that: proposals, not observed practices.[8] It is a major aim of this article to enumerate and elucidate the disincentives of most significance to institutions with shareholdings in listed Australian companies.

B. *Overview*

The article characterises disincentives to institutional monitoring as legal barriers, economic barriers, and practical and political barriers. In regard to legal disincentives, several provisions in the *Corporations Law*, including those dealing with insider trading and shadow directors, may, in some circumstances, serve as legal barriers to institutional activism. However, probably the primary legal barrier arises from the expansive definition in the *Corporations Law* of the terms "entitlement", "relevant interest", and "associate". The wide definition of those terms gives rise to the very real possibility that a loose grouping of institutional shareholders could be deemed to have breached one or more of the provisions governing disclosure of substantial shareholdings, or even the "mandatory takeover bid" provision (section 615).

As regards economic barriers, economic theory (supported by some empirical studies) suggests that a fund-management firm which has predominantly external assets under management (an "external fund manager") faces numerous disincentives to detailed monitoring. These economic disincentives reflect an agency problem at the level of fund manager:client. They arise as a result of, amongst other things: (a) the fact that the external fund manager (but not necessarily the client) will often stand to gain more from "exit" rather than "voice"; (b) collective-action problems; (c) the fact that in the usual case the performance of an external fund manager is assessed relative to that of its competitors, rather than absolutely, such that costly monitoring will only rationally be undertaken in limited circumstances; and (d) conflicts of interest. Some of these disincentives are also faced by fund managers which manage predominantly internal funds (for example, the investment-management arms of insurance companies). It is, however, more likely to be in the self-interest of such fund managers to engage in costly monitoring than it is for external fund managers.

Practical barriers to detailed monitoring include logistical difficulties associated with collective action by two or more institutions; lack of information; and a requirement to obtain client approval before acting.

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7 Coffee, J C, "Liquidity Versus Control: The Institutional Investor as Corporate Monitor" (1991) 91 *Columbia LR* 1277 at 1361.

8 To be fair, Gilson and Kraakman do address in considerable detail the issue of legal barriers to detailed monitoring: above n4 at 894–903. They devote little attention, however, to economic disincentives other than the collective-action problem.

C. *Preliminary Matters*

Before the discussion turns to the legal disincentives to detailed monitoring, there are four matters of a preliminary nature which need to be addressed.

First, the premise of this article is that monitoring by institutional shareholders is desirable.[9] The objective of the article is thus not merely to identify barriers to institutional activism, but also (where possible) to suggest ways of overcoming or removing those barriers.

The second preliminary point concerns the term "monitoring". It is used in this article to cover both routine actions and extraordinary actions taken by fund managers in regard to investee companies. Routine actions undertaken by investment managers include meeting regularly (perhaps once per year or every six months), on a one-to-one basis, with the chief executive, finance director or both of investee companies; attending post-results presentations, "roadshows", brokers' lunches, and the like; and analysing companies' financial reports and information provided by securities analysts. Extraordinary actions include attempting to influence the outcome of proposed large transactions requiring shareholder consent, both at the "pre-marketing" stage[10] and at the general meeting (if the matter goes that far); and objecting to executive share option schemes which do not comply with best practice.[11] Another form of extraordinary action is intervention to change the composition of the underperforming (or otherwise unacceptable) board of an investee company. This is a relatively recent phenomenon in Australia. Highly publicised instances occurred at Goodman Fielder Ltd[12] in 1994 and at Coles Myer Ltd[13] in 1995.

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9 This issue is discussed (briefly) below nn58–65, and accompanying text; and extensively in Stapledon, G, *Institutional Shareholders and Corporate Governance* (1996) (forthcoming) ch 9.

10 See, eg, Syvret, P, "Central to Spin Off Diamonds" *Australian Financial Review* 15 February 1994 at 20: "Great Central Mines NL is poised to announce a major reconstruction which will see the company's diamond interests spun off into a separate, publicly listed company ... Some institutional shareholders in Great Central are understood to have been sounded out on the details of the restructuring in recent days. The looming diamond spin-off, according to some institutional investors, was one of the attractions behind Great Central's recent capital raisings, which have seen the group raise about $100 million in the last two months."

11 See, eg, Mitchell, S, "Goodman Revises Option Scheme" *Australian Financial Review* 21 November 1990 at 22; Hewett, J, "Wielding the Institutional Club" *Australian Financial Review* 9 August 1993 at 15; Wood, L, "Not Everyone Happy at Coles" *Australian Financial Review* 26 November 1993 at 32. Best practice according to the Australian Investment Managers' Association (AIMA) is set out in AIMA, *Executive Share Option Schemes Guidelines* (1994) AIMA, Sydney.

12 See Bartholomeusz, S, "Power Fight Certain to Change Face of Goodman" *Age* 2 August 1994 at 41; Knight, E, "Board Won't Sit with Shears — Ultimatum from Goodman Fielder Directors" *Sydney Morning Herald* 10 August 1994 at 41; Syvret, P, "Goodman — The Final Showdown" *Australian Financial Review* 17 August 1994 at 1; Deans, A and Syvret, P, "Goodman Faces 2 Months' Uncertainty" *Australian Financial Review* 22 August 1994 at 24; Ries, I, "Chanticleer: The Goodman War is Over — But Lasting Peace Needs Working On" *Australian Financial Review* 8 September 1994 at 64.

13 See Hurst, J and Pheasant, B, "Scandal Rocks Coles Myer" *Australian Financial Review* 5 September 1995 at 1; Deans, A, "Corporate Coup Begins" *Australian Financial Review* 15 September 1995 at 2; Stevens, M and Gluyas, R, "AMP Declares War on Coles" *Australian* 12 October 1995 at 1; Hurst, J, "Myer Family Dumps Lew" *Australian Financial Review* 13 October 1995 at 1; Hurst, J, "Institutions Unite Against Lew" *Australian*

Prior to those cases, there were institutional interventions at Darrell James Ltd[14] and Bennett & Fisher Ltd[15] in 1991, as well as institutional involvement in the resignation of the non-executive chairman and four non-executive directors of Westpac Banking Corporation in 1992.[16] The fact that some instances of very detailed monitoring have occurred recently in Australia shows that the disincentives discussed in this article are sometimes surmountable. An explanation of why institutions would wish to surmount the hurdles to detailed monitoring is proffered after the completion of the discussion of disincentives. Attention is focused particularly on the institutional intervention at Coles Myer Ltd in late 1995.

The third preliminary point concerns the significance of institutional shareholders in the Australian corporate sector. As at the mid-1990s, institutional shareholders were in relative terms less significant players in the Australian corporate sector than in the corporate sectors of the US and the UK. This assertion is based upon the following facts. First, as Table 1 shows, domestic stock-exchange-listed companies did not account for as great a proportion of the largest non-financial companies in Australia as in the UK, at the end of 1994. At that time, domestic listed companies constituted 62.8 per cent of the largest 500 non-financial companies in the UK, but only 35.2 per cent of the largest 500 non-financial companies in Australia. Likewise, domestic listed companies generated 77.6 per cent of the sales revenue of the largest 500 non-financial companies in the UK, compared to only 51.2 per cent in Australia. The importance of this phenomenon is that the great majority of the equity investments of Australian (and UK and US) institutional investors has always been in listed, rather than unlisted, companies.[17] Secondly, when the focus is switched to listed companies, it is apparent that institutions owned a substantially smaller proportion of total listed domestic equities in Australia than in the US or the UK, at 1994–95. As Table 2 shows, the figures were: Australia: 32.5 per cent; UK: 59.8 per cent; US: 51.5 per cent.

Financial Review 18 October 1995 at 1; Hurst, J, "Coles Myer: Over and Out" *Australian Financial Review* 20 October 1995 at 1.

14 See McIlwraith, I, "Shareholder Revolt Rocks Darrell James" *Australian Financial Review* 9 August 1991 at 16; McIlwraith, I, "Photo Finish for Darrell James" *Australian Financial Review* 9 September 1991 at 64; Owen, R, "Darrell James Coup Blocked" *Australian* 14 September 1991 at 43; McIlwraith, I, "Darrell James Board on Notice" *Australian Financial Review* 16 September 1991 at 21.

15 See White, A, "B&F Dissension Over Property Deal Vote" *Australian Financial Review* 30 November 1990 at 23; Wood, L, "New Bennett Board Promises Stability" *Australian Financial Review* 16 December 1991 at 24; White, A, "Former Bennett Chief Finally Heeds the Call" *Australian Financial Review* 5 June 1992 at 21.

16 See Boyd, A, "Westpac: Neal and Four Directors Go" *Australian Financial Review* 2 October 1992 at 1; Lewis, S and Kaye, T, "'Still a Long Way to Go' for Westpac" *Australian Financial Review* 2 October 1992 at 26.

17 For example, as at 30 June 1995, the Australian equity investments of 55 of the 56 members of the AIMA composed 27.58 per cent of the firms' total funds under management; the figure for *listed* Australian equities was 27.30 per cent, whilst that for *unlisted* Australian equities was just 0.28 per cent: AIMA, *Funds Under Management Survey as at 30 June 1995: Results and Analysis* (1995) AIMA, Sydney, at 7.

Table 1

Structure of Australian and UK corporate sectors: Top 500 non-financial companies, 1994

Type of company	Companies		Turnover	
	number	% of total	A$m/£m	% of total
AUSTRALIA				
Listed domestic[a]	176	35.2	227 514	51.3
Unlisted domestic	130	26.0	56 211	12.7
Foreign	137	27.4	97 141	21.9
Government-owned	57	11.4	63 015	14.2
Total	500	100	443 881	100
UK				
Listed domestic	314	62.8	581 714	77.6
Unlisted domestic	51	10.2	34 071	4.5
Foreign	125	25.0	115 268	15.4
Government-owned	10	2.0	18 294	2.4
Total	500	100	749 347	100

Source: Author's analysis of information in "ABM Top 500 Companies" *Australian Business Monthly* December 1994 at 60, and Extel Financial, *The Times 1000* (1994).

a Includes three New Zealand-based companies listed on the Australian Stock Exchange (ASX).

Table 2

Ownership of Australian, US and UK equities, 1994–5

Sector of beneficial owner	Benefical ownership of listed domestic equities (%)		
	Australia[a]	US[b]	UK[c]
INSTITUTIONS			
Insurance companies	24.1	2.5	21.9
Pension/superannuation funds		29.6	27.8
Unit trusts/mutual funds, investment trusts and other financial institutions	8.4	19.4	10.1
Sub-total: institutions	32.5	51.5	59.8
NON-INSTITUTIONS			
Individuals and other personal sector	22.0	—	21.6
Public sector	1.6	—	0.8
Industrial and commercial companies	8.9	—	1.1
Overseas	31.8	—	16.3
Banks[d]	3.2	—	0.4
Sub-total: non-institutions	67.5	48.5	40.2
TOTAL	100	100	100

Sources: Central Statistical Office, *Share Ownership: A Report on the Ownership of Shares at 31st of December 1994* (1995); ASX, *ASX All Ordinaries Index Companies Handbook* (6th edn, 1995) at 26; Brancato, C K, *The Brancato Report on Institutional Investment* (1995).

a As at 31 March 1995.

b As at 30 September 1994.

c As at 31 December 1994.

d Australian figure for banks includes non-bank financial intermediaries. Holdings of banks are not classified as institutional shareholdings for present purposes. Many Australian, US, and UK banks have fund-management arms which *manage* equities on behalf of superannuation funds and other beneficial owners, but the shares *owned beneficially* by banks are mostly either corporate holdings or the result of debt-for-equity swaps; they are not portfolio investments.

The figures for Australia in Table 2 are reinforced by those in Table 3. Table 3 shows that, as at 31 August 1995, almost half of the operational Australian companies in the ASX All Ordinaries Index had a *non*-institutional shareholder which was in a position of absolute or effective control. An institution was the largest or only substantial shareholder[18] in only 33.6 per cent of All Ordinaries Index companies at that time. Where a non-institutional shareholder has a stake of such a size that a successful institutional intervention is not possible, the institutional shareholders in the company would be aware of this and would adopt an even more arm's-length approach to the investment than in the case of their investments in widely held firms. If there is a non-institutional shareholder with a shareholding of about 30 per cent or more, and it is prepared to suffer bad management, then disaffected institutions will in most cases be better off by taking an alternative course of action to monitoring.[19] In such "controlled companies", mechanisms other than institutional monitoring and the market for corporate control (takeovers) operate to ensure that the interests of professional managers do not diverge excessively from those of the controlling shareholder.[20] Nevertheless, institutional monitoring (together with related-party rules)[21] has an important role to play in controlled companies in ensuring that, in turn, the interests of minority shareholders are not ignored by the controlling shareholder.[22]

18 A "substantial shareholder" is one who is entitled to not less than five per cent of any class of a company's voting shares: *Corporations Law*, s708.

19 The outcome in the Darrell James case (see above n14) emphasises this point. The company chairman — who controlled 33 per cent of the equity — fought off an institutional challenge at an extraordinary general meeting (but not before purchasing a further 3 per cent of the equity in the market).

20 See Lawriwsky, M L, "Some Tests of the Influence of Control Type on the Market for Corporate Control in Australia" (1984) 32 *J Indust Econ* 277 at 279.

21 See *Corporations Law*, Part 3.2A; ASX, *Official Listing Rules*, LR 3J(3).

22 The possibilities for abuse of minority shareholders by controlling corporate shareholders are illustrated well by the Independent Resources litigation: *Re Spargos Mining NL* (1990) 3 ACSR 1; *Jenkins v Enterprise Gold Mines NL* (1992) 6 ACSR 539. In regard to inter-investor conflicts, see Ramsay, I M and Blair, M, "Ownership Concentration, Institutional Investment and Corporate Governance: An Empirical Investigation of 100 Australian Companies" (1993) *MULR* 153 at 173–6.

Table 3
Share ownership and control in All Ordinaries Index companies[a]

	1993		1995	
	No of companies	% of index[a]	No of companies	% of index[a]
Largest/only substantial shareholder a non-institution stake ≥ 30%	98	41.9	96	35.8
Largest/only substantial shareholder a non-institution 20% ≤ stake < 30%	26	11.1	22	8.2
Largest/only substantial shareholder a non-institution 5 %≤ stake < 20%	43	18.4	49	18.3
Largest/only substantial shareholder an institution[b]	57	24.4	90	33.6
Zero substantial shareholders	10	4.3	11	4.1
Total	234	100	268	100

Source: Author's analysis of information in ASX, *ASX All Ordinaries Index Companies Handbook* (4th edn, 1993) and ASX, *ASX All Ordinaries Index Companies Handbook* (6th edn, 1995). Note that the 1993 figures were presented first in Stapledon, G P, "The Structure of Share Ownership and Control: The Potential for Institutional Investor Activism" (1995) 18 *UNSWLJ* 250 at 269–70.

a All Ordinaries Index constituents which were overseas-based companies, non-operational property trusts, or companies involved merely in equity investment, were excluded.

b All substantial shareholders that were custodians — whether bank-nominee companies or trustee companies — were ignored. An explanation is contained in Stapledon, G P, "The Structure of Share Ownership and Control: The Potential for Institutional Investor Activism" (1995) 18 *UNSWLJ* 250 at 269 (fn72).

The relatively less significant position of institutional shareholders in the listed corporate sector, and indeed in the entire corporate sector, in Australia compared to the US and the UK should be borne in mind throughout the following discussion of disincentives to institutional monitoring.

The fourth preliminary point relates to the references in this article to an interview study. The interviews were conducted by the author in Melbourne and Sydney in February 1994. The interviewees were the senior executive or a senior fund manager of 13 Australian investment-management firms, which managed listed Australian equities representing 17.3 per cent of the listed Australian equity market at 31 December 1993. The interviewees' firms included the five largest, and seven of the eight largest, managers of listed Australian equities at the end of 1993.

2. *Legal Barriers*

There are numerous statutory provisions and regulations which affect the ability and motivation of US institutional shareholders to engage in detailed monitoring of corporate managements.[23] British institutions are, on the other

23 See Black, B S, "Shareholder Passivity Reexamined" (1990) 89 *Michigan LR* 520 at 530–60; Coffee, J C, "The SEC and the Institutional Investor: A Half-Time Report" (1994) 15 *Cardozo LR* 837 at 876–902.

hand, subject to relatively few such legal constraints.[24] The extent of the legal constraints faced by Australian institutions falls somewhere between those poles. Several of the fund managers interviewed by the author said that legal constraints served as a significant deterrent to their engaging in collective action at a portfolio company. The main provisions affecting Australian institutions are detailed below.

A. *Takeover and Substantial Shareholding Provisions*[25]

i. Overview

Australia has a statutory system for regulating takeovers and, as Hill points out, the provisions "are more than capable of catching conduct not strictly associated with a takeover bid at all".[26] Part 6.7 of the *Corporations Law* contains provisions which require any person who has a "substantial shareholding" (5 per cent or more) in a company to notify the company of the substantial shareholding and afterwards of certain changes to the holding. Section 615 of the *Corporations Law* prohibits a person from acquiring shares in a company if, after the acquisition, any person would be "entitled to" more than 20 per cent of the voting shares in the company.

The concept of entitlement to voting shares is central to Part 6.7 and section 615. The definition of "[t]he shares ... to which a person ... is entitled" is so broad that Part 6.7 and section 615 could potentially be breached when several institutional investors act to some extent collectively in relation to a company in which each has a shareholding. A strong argument can be made that Part 6.7 and section 615 should not apply in this type of situation. It is desirable that the *Corporations Law* be amended to ensure that collective action by institutional shareholders on matters of corporate governance is not caught by Part 6.7 or section 615. At the time of writing the Corporations Law Simplification Task Force had, in fact, published a reform proposal which would, if adopted, probably remove the problem relating to section 615 and reduce the problem relating to Part 6.7.[27] However, due to (i) the possibility that the proposed reforms may not eventuate, and (ii) the significance of this barrier to detailed institutional monitoring, this section of the article provides a detailed analysis of the position under the current law. It concludes with an outline of the reforms, and the probable effect of the reforms, proposed by the Simplification Task Force.

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24 See Black, B S and Coffee, J C, "Hail Britannia? Institutional Investor Behavior Under Limited Regulation" (1994) 92 *Michigan LR* 1997.

25 This section is based upon a report produced by the author for the AIMA: see Stapledon, G P, *The Impact of Section 615 and Part 6.7 of the Corporations Law on Collective Action by Institutional Investors* (1995) AIMA, Sydney.

26 Hill, J, "Institutional Investors and Corporate Governance in Australia" in Baums, T, Buxbaum, R M and Hopt, K J (eds), *Institutional Investors and Corporate Governance* (1994) at 606.

27 Corporations Law Simplification Task Force, *Takeovers: Proposal for Simplification* (1996) Attorney-General's Department, Canberra.

ii. The Operation of Part 6.7 and Section 615 of the *Corporations Law*

a. Corporations Law, *Part 6.7*

Part 6.7 of the *Corporations Law*[28] contains a regime under which any person who becomes a "substantial shareholder", or whose substantial shareholding changes by a certain amount, or who ceases to be a substantial shareholder, must notify the company and the Australian Stock Exchange of certain prescribed particulars. A person has a substantial shareholding for the purposes of Part 6.7 if the person is "entitled" to 5 per cent or more of the voting shares.[29]

A person who contravenes one of the notification provisions in Part 6.7 is guilty of a criminal offence, and is subject to a fine of up to $2500 (or $12 500 if the person is a body corporate), or imprisonment for six months, or both.[30] Whether or not a person who contravenes one of the notification provisions in Part 6.7 is convicted of an offence, that person is liable to pay, to any person who suffers loss or damage as a result of the contravention, damages in respect of that loss or damage.[31] This is not the case where it is proved that the contravention was due to the inadvertence or mistake of the wrongdoer, or to the wrongdoer not being aware of a relevant fact or occurrence.[32] However, in determining whether a defence on these grounds can be made out, the person's ignorance of or mistake concerning the law must be disregarded.[33]

A contravention of one of the notification provisions in Part 6.7 may have further consequences. First, the Australian Securities Commission (ASC) or the company concerned may apply to the court for an order under section 741. The court may make such orders as it thinks just, including orders restraining the exercise of voting rights, directing the disposal of the shares, or vesting the shares in the ASC.[34] Secondly, section 1324 could be utilised. Under section 1324, the ASC or any person whose interests are, have been, or would be affected by a breach of the Corporations Law has standing to apply to the court for an injunction or damages. The particular importance of this for institutional investors is detailed later.

b. Corporations Law, *Section 615*

Section 615(1) prohibits an acquisition of shares in a company if it would result in (a) any person presently entitled to less than 20 per cent of the voting shares in the company becoming entitled to more than 20 per cent of the voting shares; or (b) any person already entitled to between 20–90 per cent of the voting shares becoming entitled to a greater percentage of the voting shares.[35]

28 Part 6.7 applies to all listed companies and to any unlisted companies specified by the Minister: *Corporations Law*, s707(1).

29 *Corporations Law*, s708(1). Where a company's voting shares are divided into two or more classes, a person has a substantial shareholding if entitled to 5 per cent or more of the shares in one of those classes: s708(1)(b).

30 *Corporations Law*, ss1311, 1312; schedule 3 (and s9: definition of "penalty unit").

31 *Corporations Law*, s716(1).

32 *Corporations Law*, s716(1).

33 *Corporations Law*, s610.

34 *Corporations Law*, ss741, 613(1); cf s743.

35 *Corporations Law*, ch 6 specifies numerous exceptions to this prohibition: eg for acquisitions under takeover schemes and takeover announcements, and for creeping acquisitions.

Any person who breaches the prohibition in section 615 is guilty of a criminal offence, and is subject to a fine of up to $2500 (or $12 500 if the person is a body corporate), or imprisonment for six months, or both.[36] A person prosecuted under section 615 has a defence if it is proved that the contravention was due to inadvertence or mistake or to the person not being aware of a relevant fact or occurrence.[37] However, in determining whether a defence on these grounds can be made out, the person's ignorance of or mistake concerning the law must be disregarded.[38]

An acquisition of shares is not invalid because of a contravention of section 615.[39] Nevertheless, the ASC, the company concerned, a member of the company, or the person from whom the shares were acquired, may apply to the court for an order where there has been a breach of section 615(1). The court may make such orders as it thinks just, including orders restraining the exercise of voting rights, directing that an exercise of voting rights be disregarded, directing the disposal of the shares, or vesting the shares in the ASC.[40] Also of relevance where there has been a breach of section 615 is section 1324, which was outlined earlier.

c. *The Concepts of "Entitlement", "Relevant Interest", and "Associate"*

The crucial concept in Part 6.7 and section 615 is "entitlement" to shares. The shares to which a person is entitled include not only shares in which that person has a "relevant interest", but also shares in which an "associate" has a relevant interest.[41] A person has a relevant interest in a share if the person has power to vote in respect of that share, or power to dispose of that share.[42] An associate includes a person *in concert* with whom the primary person is acting or proposes to act;[43] and a person with whom the primary person has, or proposes to enter into, an *agreement, arrangement, or understanding* (formal or informal, written or oral, legally enforceable or otherwise) for the purpose of controlling or influencing the composition of the company's board or the conduct of the company's affairs.[44]

iii. Applicability of Part 6.7 and Section 615 to Institutional Investors

As shown above, "entitlement" to voting shares is the key concept in Part 6.7 and section 615, and "relevant interest" and "associate" are the two key elements in determining a person's entitlement to voting shares. In the following two subsections, the concepts of relevant interest and associate are examined in the context of institutional shareholders. Following that, there is a description of how Part 6.7 and section 615 could be contravened as a result of collective action by institutional investors.

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36 *Corporations Law*, ss1311, 1312; schedule 3 (and s9: definition of "penalty unit").

37 *Corporations Law*, s615(5).

38 *Corporations Law*, s610.

39 *Corporations Law*, s615(6).

40 *Corporations Law*, ss737, 613(1); cf s743.

41 *Corporations Law*, s609(1).

42 *Corporations Law*, s31. See also ss30(2)–(5), 36.

43 *Corporations Law*, s15(1)(a).

44 *Corporations Law*, ss12(1)(e), 9. Other persons are also deemed to be associates: see ss10–17. In particular, the associates of a body corporate include (a) its directors and secretary(ies); (b) related bodies corporate; and (c) directors and secretaries of related bodies corporate: s11.

a. Institutional Investors and the "Relevant Interest" Concept

It is clear that virtually all Australian institutional investors (whether they be insurance companies, in-house managers of superannuation funds, or investment-management firms which manage the assets of external clients such as superannuation funds and charities) would have a relevant interest in the Australian equity investments in their portfolios. This is because, as stated above, the definition of relevant interest includes not only power to vote in respect of a share, but also power to dispose of a share. Australian insurance companies have always had both of these powers over the equities in their statutory funds. Almost all investment-management firms which manage external funds would always have had the power to dispose of equity investments. In the past, a number of such investment managers did not have voting power over equity investments. However, by 1994, most Australian fund managers had the power to vote as well as to dispose of their clients' equity investments.[45]

b. Institutional Investors and the "Associate" Concept

Assume A (a fund-management firm), B (a fund-management firm), C (an insurance company), and D (the in-house investment manager of a superannuation fund) each have a relevant interest in the voting shares of Z Ltd (an ASX-listed company). It is likely that many forms of collective action that A, B, C, and D might potentially take in relation to Z Ltd would result in A, B, C, and D becoming associates of one another.

For example, if the managing director of Z Ltd was performing in a grossly unsatisfactory manner, to the serious detriment of Z Ltd's profitability, and if there were no effective non-executive directors on Z Ltd's board, then A, B, C, and D might legitimately and independently decide that this was an appropriate case for requisitioning the board to convene a general meeting,[46] at which a resolution would be proposed that the managing director be removed under the power conferred by section 227 of the *Corporations Law*. Dialogue of any sort between A, B, C, and D in regard to this proposed course of action could easily result in their becoming associates. They may well be construed as acting "in concert" with one another (within the meaning of section 15(1)(a)),[47] and they may well be construed as having an "agreement, arrangement or understanding ... for the purpose of controlling or influencing the composition of [Z Ltd's] board" (within the meaning of section 12(1)(e)(i)). Either finding would constitute them associates.[48]

Consider another example — involving a much less extreme form of institutional shareholder action. Assume that A, B, C, and D all decide, independently,

45 See Australian Institute of Superannuation Trustees Inc (AIST), *Corporate Governance in Australia: The Attitudes and Practices of Funds Managers* (1994) AIST, Melbourne.

46 See *Corporations Law*, s246. See also *Second Corporate Law Simplification Bill 1995 — Exposure Draft*, s249D.

47 Note, however, that a "mere coincidence of separate acts is insufficient" to establish two or more parties as acting in concert: *Adsteam Building Industries Pty Ltd v Queensland Cement & Lime Co Ltd (No 4)* (1984) 14 ACLR 456 at 459.

48 It should be noted that if A and B were to make a voting agreement as to how their shares in Z Ltd were to be voted, each would have "power ... to control the exercise of the [other's] right to vote" (s30(2)), and each would have a relevant interest in respect of the other's shares: *TVW Enterprises Ltd v Queensland Press Ltd (No 2)* (1983) 7 ACLR 821.

to vote against a resolution to implement an executive share option scheme, which is on the agenda for the forthcoming AGM of Z Ltd.[49] Communication or other interaction between A, B, C, and D in regard to this agenda item might well result in them being deemed to be associates. They may be construed as acting "in concert" with one another (within the meaning of section 15(1)(a)), and they may be construed as having an "agreement, arrangement or understanding ... for the purpose of controlling or influencing the conduct of affairs of [Z Ltd]" (within the meaning of section 12(1)(e)(ii)).

A finding that A, B, C, and D were associates would mean, of course, that each of them would be "entitled" to the Z Ltd shares in which A has a relevant interest, to the Z Ltd shares in which B has a relevant interest, to the Z Ltd shares in which C has a relevant interest, and also to the Z Ltd shares in which D has a relevant interest!

c. *Institutional Investors and Part 6.7*

If, in either of the examples given above, A and B each have a relevant interest in 1 per cent of Z Ltd's voting shares, and C and D each have a relevant interest in 2 per cent of Z Ltd's voting shares, then, as soon as they become associates through their dialogue as described above, they would each be entitled to 6 per cent of the voting shares of Z Ltd. Each would therefore be obliged under section 709 (in Part 6.7) to give a substantial shareholding notice to Z Ltd (and a copy to the ASX) within two business days of becoming aware of "the relevant interest or interests because of which [it became] a substantial shareholder".[50] Thereafter, each would have to notify Z Ltd and the ASX under section 710 (within two business days) if there was a "notifiable change"[51] in its entitlement which resulted in its entitlement falling to 5 per cent or increasing to 7 per cent or more. Alternatively, each would have to notify Z Ltd and the ASX under section 711 (within two business days) if it ceased to be a substantial shareholder (that is, if it ceased to be entitled to at least 5 per cent of Z Ltd's voting shares).

d. *Institutional Investors and Section 615*

If, in either of the two examples given earlier, A has a relevant interest in 4 per cent, B has a relevant interest in 5 per cent, C has a relevant interest in 6 per cent, and D has a relevant interest in 7 per cent of Z Ltd's voting shares, then, as soon as they become associates through their dialogue as described above, they would each be entitled to 21 per cent of the voting shares of Z Ltd. If one of them were subsequently to make an "acquisition of shares"[52] in Z Ltd, that institution would contravene section 615 if none of the permitted takeover provisions applied.[53]

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49 A similar situation has arisen occasionally in Australia: see above n11.

50 *Corporations Law*, s709(4).

51 See *Corporations Law*, s708(6), (7).

52 See *Corporations Law*, ss51, 64.

53 As an old edition of the leading Australian corporate law text said: "It is worth emphasizing that the legislation applies to all acquisitions of shares which fall within the basic prohibition, whatever be the motive of the acquirer and in particular, whether or not the acquirer intends to make a take-over bid": Ford, H A J and Austin, R P, *Ford's Principles of Corporations Law* (6th edn, 1992) at 707.

Section 615 is, however, for two reasons, less likely to be breached than Part 6.7. First, the threshold for Part 6.7 is 5 per cent of the voting shares whereas the threshold for section 615 is 20 per cent of the voting shares. Nevertheless, with the rapidly growing size of funds under the management of Australian institutional investors, and the resultant increase in concentration of institutional shareholdings, it is now not uncommon for a handful of the largest institutional shareholders in any given company to represent more than 20 per cent of the equity capital. The second reason why section 615 is likely to be less of a concern to institutions than Part 6.7 is that section 615 has the extra requirement that there must be an acquisition of shares.[54] Nevertheless, in the case of most large Australian institutions, the total shareholding in a particular company consists of many — possibly dozens of — separate holdings for particular funds, clients or both. The acquisition element of section 615 could therefore be satisfied almost unintentionally — for example, by an "index" purchase of shares for a unit trust which tracks an ASX index of which the particular company is a constituent.

iv. Practical Relevance for Institutions of Breaching Part 6.7 or Section 615

It might be argued that the foregoing is largely academic, and that in practice there is little likelihood of institutions ever suffering any consequences as a result of a "technical" breach of Part 6.7 and section 615. Any such argument would, for two reasons, be misconceived. First, several interviewees in the author's interview project said that the potential application of these provisions served as a significant deterrent to their engaging in collective action at an investee company. Second, the overseas experience suggests that there is cause for concern. In the US, where there are provisions similar to those in Part 6.7 of the *Corporations Law*, lawyers who advise corporate managements provided the following advice in a public forum:

> [I]f several institutional investors communicate with each other with respect to an election of registrant directors or an alternative slate of nominees, registrants should consider asserting the application of Schedule 13D [that is, the equivalent of Part 6.7 of the *Corporations Law*].[55]

It is reasonable to expect that equivalent advice would be given by advisers to an Australian corporate management which was the subject of some form of exercise of shareholder democracy by more than one institutional investor. A significant weapon in this context could be section 1324 of the *Corporations Law*, which is outlined above. The impugned directors could bring an application under section 1324 in the name of the company,[56] alleging a breach of Part 6.7, section 615 or both. Whether or not any remedy was justified, the very prospect of the expensive litigation which this scenario entails would possibly be sufficient to deter institutions from exercising their shareholder rights in the first place.[57] There is, in addition, the deterrent effect of the

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54 See above n26 at 607.

55 Cited in Black, B S, "Next Steps in Proxy Reform" (1992) 18 *J Corp L* 1 at 51–2.

56 There can be little doubt that the company would be "a person whose interests have been ... affected" by the contravention, as required for standing under s1324.

57 See also below nn166–79, and accompanying text.

potential for criminal prosecution, as described earlier. All of this may have significant implications for Australia's system of corporate governance, which is expanded upon in the next subsection.

v. The Inherent Incompatibility

In the US, the UK, Canada, and Australia (amongst other places), over the past few years, a consensus has developed that a properly functioning system of corporate governance in the quoted corporate sector requires the exercise, where appropriate, of shareholder rights by institutional investors.[58] This has been recognised recently by the chairman of the ASC, when he stated that shareholder action is "central to the proper functioning of our capital markets".[59] In the same vein, one of Australia's most prominent company directors, Mr David Greatorex, opined in 1994 that shareholders are the key to prevention of a recurrence of the corporate collapses of the late 1980s.[60] The AIMA (known initially as the Australian Investment Managers' Group (AIMG)) itself grew out of the dissatisfaction felt by several major Australian institutional investors with the "Wall Street walk" approach adopted by many Australian institutions in the 1980s.[61]

Some recent and proposed reforms to the *Corporations Law* reflect legislative recognition of this growing role for shareholders. For instance, the "related party" provisions which were introduced in 1993 give to shareholders the responsibility of deciding whether or not to ratify certain transactions between public companies and parties related thereto.[62] The ASC chairman said in 1994 that "the related party transactions rules ... depend for their efficacy on investors paying attention to the affairs of the corporations in which they invest".[63] Also, the previous federal government proposed to insert a statutory derivative action into the *Corporations Law*, under which a shareholder could obtain leave of the court to bring a legal action on behalf of a company.[64]

The potential for collective action by institutions to contravene Part 6.7 or section 615 of the *Corporations Law*, or both does not sit comfortably with a model of corporate governance in which monitoring by institutional shareholders plays an important role. Despite recent increases in shareholding concentration levels in listed Australian companies[65] (due largely to growth in

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58 See, eg, Black, B S, "Agents Watching Agents: The Promise of Institutional Investor Voice" (1992) 39 *UCLA LR* 811; Davies, above n1; Ramsay and Blair, above n22; Black and Coffee, above n24; Stapledon, above n9; cf, however, Morgan, H M, "Dealing with Institutional Shareholders: A Corporate Perspective" (unpublished paper presented at the Australian Investment Managers' Group/Business Council of Australia conference on "Corporate Governance and Australian Competitiveness: The Role of Institutional Investors", Sydney, 11 November 1993).

59 Callick, R, "Shareholders Urged to be Vigilant by ASC's Chief" *Australian Financial Review* 23 March 1994 at 7.

60 See Tabakoff, N, "Shareholders 'Key to Corporate Stability'" *Australian Financial Review* 9 March 1994 at 7.

61 See Hewett, above n11.

62 See *Corporations Law*, Part 3.2A.

63 Above n59.

64 See Attorney-General's Department, *Proceedings on Behalf of a Company (Statutory Derivative Action): Draft Provisions and Commentary* (1995) Attorney-General's Department, Canberra.

65 See Ramsay and Blair, above n22 at 165–71.

institutional share ownership), action by institutional shareholders would still normally need to be "collective", to some extent, in order to be effective — that is, in order to amass sufficient votes for a successful outcome. There is, therefore, an inherent incompatibility between, on the one hand, widespread exhortation of institutional investors to make better use of the rights attached to their shareholdings and conferred by the *Corporations Law*, and, on the other hand, a statutory regime which positively *discourages* any form of collective action in this regard.

vi. Possible Reform

It was mentioned earlier that the Corporations Law Simplification Task Force has released a reform proposal which would, if adopted, probably remove the problem relating to section 615 and reduce the problem relating to Part 6.7.[66] The latter part of this subsection comprises a brief description of the Simplification Task Force's proposals. At the time of writing, however, it was by no means certain that all of the Task Force's proposals would be legislated.[67] In the light of this, the first part of this subsection makes a case for, and outlines a possible, reform of the *Corporations Law* to limit the width of the "entitlement" concept. In so doing, a rationale is incidentally provided for the Simplification Task Force's proposed reforms in this area.

It is possible to distinguish between two broad classes of institutional shareholder actions: those concerned with, and those not concerned with, corporate control. The first example of an institutional intervention, given earlier, is an example of action by institutional shareholders which involves alteration (or potential alteration) to corporate control. However, many matters on which institutions act collectively have nothing to do with alteration (or potential alteration) to corporate control. The second example given earlier is a case in point.

It is almost beyond argument that the legislature would not have intended Part 6.7 or section 615 to "catch" joint institutional action on matters unconnected to corporate control. Thus, for this class of institutional action there is a very strong case for legislative reform. A possible reform might be to add a "specified exclusion" to those already specified in section 16(1) of the *Corporations Law*. Section 16(1) states: "A person is not an associate of another person by virtue of section 12 or subsection 15(1) ... merely because of one or more of the following: ..." By this mechanism, section 16(1) ensures that certain persons are not deemed to be associates. This is, of course, crucial in limiting the "entitlement" of those persons to voting shares in the company concerned.

It is not as clear immediately that collective institutional action on matters related to corporate control should be removed from the reach of Part 6.7 and section 615. Nonetheless, there are at least three very persuasive arguments in favour of extending the legislative reform suggested in the previous paragraph so as to also cover control-related collective action.

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66 See above n27, and accompanying text.

67 Note, though, that, prior to winning office, the coalition parties expressed their support for the simplification process generally: *Liberal and National Parties' Law and Justice Policy* (1996).

First, the Corporations Law contains provisions which reflect a legislative intention that shareholders should be able to act collectively in control-related matters. Section 246 enables shareholders to group together to requisition the directors to convene an extraordinary general meeting, and section 247 empowers shareholders to themselves convene a general meeting.[68] Section 252 empowers a group of shareholders to requisition the company to notify shareholders of a resolution to be moved at the next annual general meeting, and to distribute a circular relating to any proposed resolution or business to be dealt with at any general meeting.[69] In addition, and importantly, section 227 empowers the shareholders of a public company to remove a director, by ordinary resolution, without cause.

Second, the international experience indicates that collective institutional action affecting corporate control should be removed from the reach of Part 6.7 and section 615. In regard to the US, in late 1992 the US Securities and Exchange Commission (SEC) amended some of the "proxy rules" made under the *Securities Exchange Act* 1934 (US), so as to remove restrictions on the ability of institutional investors to act collectively. The amendments did not, however, remove all of the obstacles.[70] One remaining obstacle stems from a provision (Rule 13d-5(b)(1)) which is similar in effect to Part 6.7 of the *Corporations Law*. There have been calls for the SEC to reform Rule 13d-5(b)(1), which embraces a concept of a "voting group" which operates remarkably similarly to the "entitlement" concept in the *Corporations Law*. One influential commentator has submitted:

> [A]t a minimum, the voting group concept should be cut back to exclude shareholders who are engaged in organizing support for a non-control-related vote. ... [I]t is arguable that a solicitation intended to elect only a minority of the [board] seats up for election might be similarly excluded.[71]

In Canada, the takeover-bid provisions in provincial securities legislation[72] operate similarly to section 615 of the *Corporations Law*. A leading Canadian corporate law scholar has contended:

> There is ... a very strong case for completely exempting institutional owners ... from the application of the takeover rules, unless the ... institutions actively make or participate in an offer to all shareholders ... [C]oordinated institutional activity to influence management on an *ad hoc* basis [should not] be subject to aggregation ... [A]pplying the rules to such conduct will harm all shareholders by interfering with institutional monitoring.[73]

Institutional shareholders in UK companies are probably not faced with the type of legal disincentives currently under discussion. The *Companies Act*

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68 The power in s247 exists only "[s]o far as the articles do not make other provision": s247(1); *LC O'Neil Enterprises Pty Ltd v Toxic Treatments Ltd* (1986) 10 ACLR 337. See also *Second Corporate Law Simplification Bill 1995 — Exposure Draft*, ss249D, 249F.

69 See also *Second Corporate Law Simplification Bill 1995 — Exposure Draft*, ss249N, 249P, 249Q.

70 See Dixon, C T, "The Post-Proxy Reform Era: Remaining Pitfalls for the Unwary Activist Shareholder" *Corporate Governance Advisor* October/November 1993 at 12; Coffee, above n23 at 876–902.

71 Coffee, id at 882.

72 For example, *Securities Act* 1990 (Ontario), ss89(1), 91.

73 MacIntosh, J G, "The Role of Institutional and Retail Investors in Canadian Capital Markets" (1993) 31 *Osgoode Hall LJ* 371 at 405–6.

1985 (UK) contains provisions which have the same goal as Part 6.7 of the *Corporations Law* (disclosure of substantial shareholdings).[74] However, the sections dealing with aggregation of the shareholdings of associated persons (sections 204 to 206) would, in most instances, not catch a coalition of institutions formed to engage in some kind of corporate-governance activity. Section 205 aggregates shareholdings where there is an "agreement"[75] to which section 204 applies. Significantly, section 204 applies only to an agreement which:

i "includes provision for the acquisition by any one or more of [the parties to the agreement] of interests in shares of a particular public company";

ii "also includes provisions imposing obligations or restrictions on any one or more of the parties to it with respect to their use, retention or disposal of their interests in that company's shares acquired in pursuance of the agreement"; and

iii is fulfilled to the extent that any one or more of the parties actually acquires an interest in the company's shares "in pursuance of the agreement".[76]

An institutional intervention would not usually satisfy the requirements that there be an agreement to acquire, and then an agreement-related acquisition of, an interest in the company's shares.[77] In regard to takeover regulation, the UK's *City Code* requires that the shareholdings of "persons acting in concert with" a person must be aggregated with the shareholding of that person when determining whether a mandatory bid must be made by that person (the threshold being 30 per cent of the voting rights).[78] Although this might at first seem to have an effect similar to section 615 of the *Corporations Law*, in terms of its impact on collective action by institutional shareholders, that is almost certainly not the case once one takes into account the fact that the *City Code* is a non-statutory document — administered, interpreted, and enforced by the Panel on Takeovers and Mergers, a body "composed ... of market professionals in the securities industry [which] prides itself on its speed and lack of formality ... and normally ... does not allow representation by legally skilled persons."[79] It is submitted that it is very unlikely that the Panel would adopt a legalistic and technical approach to Rule 9.1 of the *City Code* so as to force a coalition of institutions engaged in a corporate-governance action to make a mandatory bid.[80] Indeed, two US commentators (prominent in the fields of corporate law,

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74 See *Companies Act* 1985 (UK), ss198–210.

75 Defined broadly: see *Companies Act* 1985 (UK), s204(5), (6).

76 *Companies Act* 1985 (UK), s204(1), (2).

77 It should be noted, however, that an interest in shares may be acquired without a purchase of any shares. Section 208(2) states that a "reference to an interest in shares is to be read as including an interest of any kind whatsoever in the shares", and s208(4)(b) deems a person to have an interest in shares if "not being the registered holder, [the person] is entitled to exercise any right conferred by the holding of the shares or is entitled to control the exercise of any such right".

78 Panel on Takeovers and Mergers, *The City Code on Takeovers and Mergers*, Rule 9.1.

79 Prentice, D D, "Regulation of Takeover Bids in the United Kingdom" in Kreuzer, K (ed), *Öffentliche Übernahmeangebote* (1992) at 139.

80 This view is reinforced by one of the Panel's own interpretative notes: see above n78, Notes on Rule 9.1, Note 2: "The Panel does not normally regard the action of shareholders voting together on particular resolutions as action which of itself should lead to an offer obligation".

securities regulation, and corporate finance) have called for further relaxation of SEC regulations on the express ground that, in the UK, the presence of very low legal barriers to collective institutional action has not resulted in criticism of institutions for excessive interference.[81] Research has shown that institutions have acted collectively to replace directors of listed UK companies only in very extreme circumstances — such as where there has been sustained gross under-performance, strong evidence of misconduct or both.[82] A majority of interested persons in the UK (including both of the main political parties) argue that institutional shareholders should be *more*, rather than less, activist.[83]

Flowing on from the discussion of the UK situation is the third argument in favour of including control-related collective institutional action within the reform proposed earlier. This final point is that there is little reason to expect that Australian institutions would interfere inappropriately in control-related matters if the legal barriers under discussion were removed. There are numerous *economic* disincentives to detailed involvement by institutional investors in corporate governance, which are discussed later. These would continue to act as a forceful restraint upon collective institutional action even if the above-mentioned legal barriers were dismantled.

For these reasons, it is recommended that the *Corporations Law* should be amended so as to protect from the reach of section 615 and Part 6.7 both non-control-related and control-related institutional action of a collective nature.

The Corporations Law Simplification Task Force has, as mentioned above,[84] proposed some significant reforms in this area. In regard to section 615, the Task Force proposes that the concept of entitlement be abandoned and that reliance be placed instead on a revised concept of relevant interest.[85] Of most importance for the present issue, the Task Force recommends that the concept of associate no longer be used for the purposes of section 615.[86] If adopted, this reform would, it seems,[87] eliminate the legal barrier which section 615 currently creates for collective institutional monitoring. The Task Force also proposes that Part 6.7 be amended so that a substantial shareholder would be defined by reference to its relevant interest rather than its entitlement.[88] Under this proposal, the associate concept would not be applicable in determining whether someone was a substantial shareholder. However, the Task Force proposes that substantial shareholders should be required to disclose the *identity* of their associates.[89] A consequence of the latter proposal is that the current legal barrier to collective institutional monitoring, posed by Part 6.7, would be merely reduced rather than eliminated. Even if the Task

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81 Above n24.

82 Ibid; Stapledon, above n9.

83 Stapledon, ibid.

84 See above n27, and accompanying text.

85 Id at 3, 13–4.

86 Id at 4, 15.

87 The Task Force's proposals in this area, as in some other areas, are presented very briefly. It is, therefore, somewhat difficult to determine with precision the full implications of the proposals.

88 Above n27 at 9, 20.

89 Ibid.

Force's proposal regarding Part 6.7 were to be implemented, an institution undertaking some kind of corporate-governance action at a particular company would still be at risk of breaching a Part 6.7 provision if, having a stake of at least five per cent, it did not disclose (identify) as associates any institutions with whom it was acting in concert, or with whom it had a pertinent agreement, arrangement, or understanding.[90] Nonetheless, the reforms proposed by the Task Force would remedy the main problems which section 615 and Part 6.7 currently present for combined institutional action, by taking the associate concept out of the formula for determining whether the threshold (20 per cent for section 615; five per cent for Part 6.7) has been met or exceeded. This would be a positive development for the reasons set out earlier in this subsection.

B. *Insider-Trading Provisions*

Insider trading has been outlawed in Australia, by way of specific legislation, since the 1970s.[91] It does not matter if an institution comes into possession of price-sensitive information during the course of monitoring, so long as it does not trade on it, procure another party to trade in the shares, or communicate the information to another party.[92] It is, nevertheless, arguable that the insider-trading provisions serve to restrict the amount of monitoring performed by institutional shareholders. The line of reasoning is as follows:

> [I]nstitutional investors ... cannot trade on some information which is subject to insider trading legislation. As a precaution they do not acquire it in the first place in order to not jeopardize their trading strategy. As a result they stay less informed, thereby reducing their effectiveness as monitors.[93]

It is, however, for several reasons, far from clear that the insider-trading provisions actually cause institutions to conduct significantly less monitoring than they would conduct in their absence. First, the legislation is not a barrier to routine meetings between fund managers and corporate managements. One-to-one meetings, "roadshow" presentations, and brokers' lunches are all prevalent in Australia. Secondly, it is difficult to see how the legislation could stymie interventions to replace board members, because institutions only take part in such activism after deciding not to sell their shares at the prevailing price. Thirdly, although inability to trade the shares is cited commonly as a reason why institutions oppose the idea of non-executive directors being nominated by institutional shareholders, a Chinese Wall could be utilised to enable an institution to trade the shares of a company at which one of its fund managers or a nominee was a non-executive director.[94] It appears that the

90 See above nn43–4, and accompanying text.

91 See now *Corporations Law*, Part 7.11, Div 2A.

92 This is a generalisation of the provisions in *Corporations Law*, s1002G.

93 Maug, E, "Institutional Investors as Monitors: On the Impact of Insider Trading Legislation on Large Shareholder Activism" (Working Paper 213, Institute of Finance and Accounting, London Business School, 1995).

94 See *Corporations Law*, s1002M; also s1002J (exception for underwriters). In addition, there are several other reasons usually given by institutions when explaining their antipathy to the concept of institutional non-executives: see Stapledon, above n9, chs 5, 8. These other factors would remain as strong disincentives to institutional representatives serving as non-executives even if there were no insider-trading legislation, or if institutions were exempted from it.

most likely point of impact of the insider-trading provisions is in relation to the "pre-marketing" of proposed large transactions. As one Australian fund manager said recently:

> When a company comes to us and says, "We are thinking of doing 'such and such', what do you think?" we [become] insiders and that can be to the detriment of [our] clients because we are precluded from acting in the market. So, before the discussion, we typically ask the question, "Will this make us an insider?" ... [I]f we have made a decision ... to buy shares in the company, we may say "We would prefer not to hear what you have to say."[95]

Interestingly, however, the same fund manager went on to say:

> Generally we don't decline to discuss the matter. At the end of the day it all gets back to [our] clients' interests ... I think generally the more we know about what is going on in the company the better we are able to make judgements about ... the executives and also the quality of the non-executive directors.[96]

Most institutions are willing to be made insiders in this way for only a few days at most.[97] It might be argued that without the prohibition on insider trading they would be able to become involved at an earlier stage. However, it is likely that, even in the absence of the legislation, a company's management would divulge undisclosed price-sensitive information to an institutional shareholder only if the institution first gave an undertaking not to trade in the shares until the information became public.[98] The desire for freedom to trade would ensure the same relatively short period during which the institution would be happy to be an insider.

C. *"Shadow Director"*

If an institution is "a person in accordance with whose directions or instructions the directors of [a company] are accustomed to act", that institution is deemed to be a director of that company. Any institution which is such a "shadow director" is subject to all of the provisions of the *Corporations Law* to which any director is subject. Two significant examples are the insolvent trading provisions[99] and the statutory officers' duties.[100] Whether an institution *is* a party in accordance with whose instructions the board is accustomed to act must be determined from the point of view of the board.[101] However, probably the last thing that a board, which was the subject of an institutional intervention, would do would be to act in accordance with the instructions of

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95 Above n45 at 114.

96 Ibid.

97 Finding of author's interview study.

98 Indirect support for this proposition exists in the fact that, in Germany, prior to the outlawing of insider dealing, many banks and companies followed a voluntary code of conduct proscribing insider trading: Waller, D, "Survey: German Banking and Finance: A Tightening of the Rules" *Financial Times* 31 May 1994 at II. Insider trading became an offence in Germany in 1994 under the second Financial Markets Promotion Act (*Finanzmarktförderungsgesetz*) (implementing Directive 89/592/EC).

99 *Corporations Law*, ss588G–588U.

100 *Corporations Law*, s232.

101 Prentice, D D, "Directors, Creditors, and Shareholders" in McKendrick, E (ed), *Commercial Aspects of Trusts and Fiduciary Obligations* (1992) at 81 (n39). See also *Standard Chartered Bank of Australia Ltd v Antico* (1995) 18 ACSR 1 at 65–71; *Dairy Containers Ltd v NZI Bank Ltd* (1995) 7 NZCLC 260,783 at 260,810–1.

the intervening institutions (if any were given). The obvious exception is where an impugned board agrees to appoint new directors suggested by the intervening institutions (as occurred in the Coles Myer case, for instance). Even in this situation, though, it is unlikely that any of the intervening institutions would fall within the shadow-director definition. The one-off action of the board in appointing the new directors probably would not render any of the intervening institutions a person whose instructions the board is *accustomed* to follow; when followed by "to", the postpositive adjective "accustomed" means "in the habit of"[102] (which necessitates more than one action). It should be borne in mind that intervening institutions invariably disengage themselves from active involvement once the board has been reconstituted.

D. Corporations Law, *section 1069(1)(k)*

Managers of Australian unit trusts face a serious legal obstacle to the exercise of voting rights. Section 1069(1)(k) of the *Corporations Law* requires that a unit-trust deed must contain covenants binding the trustee and manager not to vote the trust's shareholdings on any election of directors, without the prior consent of a majority of unit-holders. This provision was introduced after the court in *Australian Fixed Trusts Pty Ltd v Clyde Industries Ltd*[103] held that a trustee need not consult with beneficiaries before exercising its voting rights on an election of directors in an investee company. It was feared that a trustee might exercise its voting rights to benefit associates at the expense of unit-holders.

The Australian Securities Commission (ASC), under its discretionary powers, allows managers and trustees to vote without having to obtain the prior consent of unit-holders, but only in fairly restrictive circumstances. One requirement for an exemption is that neither the trustee, the manager, nor any of their associates holds shares in the company in a capacity other than as a trustee, or as a trustee or manager of a unit trust. Another requirement is that the trustee, the manager, and their associates are not entitled to more than 10 per cent of the voting shares.[104] These requirements, especially the first, are unnecessarily restrictive. Indeed, there is little justification for section 1069(1)(k) itself. The ASC itself came to this conclusion (following submissions from the AIMA), and recommended to the Parliamentary Joint Committee on Corporations and Securities that section 1069(1)(k) be repealed.[105] The Joint Committee was "inclined to agree" with the view of the ASC and noted that it had "received no submissions expressing support for the retention of this provision".[106] The Joint Committee could find no merit in the arguments used to support the introduction of the provision.[107] It observed:

> Both trustees and fund managers have a duty to ensure that when they exercise the voting rights of the trust shares they do so in the best interests of

102 *Collins English Dictionary: Australian Edition* (3rd edn, 1991) at 10.

103 [1959] SR (NSW) 33.

104 ASC, *Policy Statement 55* (1994) pars 112–4.

105 See Parliamentary Joint Committee on Corporations and Securities, *Issues Paper: Inquiry into the Role and Activities of Institutional Investors in Australia* (1994) Parliamentary Joint Committee on Corporations and Securities, Canberra, par 4.26.

106 Id par 4.27.

107 Id par 4.25.

> the unit holders. The Committee is not aware of any evidence of the widespread abuse of voting power by fund managers or trustees which would justify inhibiting them from exercising the rights of the unit holders as shareholders.[108]

It is submitted that section 1069(1)(k) is a counter-productive provision, and should be repealed.

E. *Power of Delegation in Trustee Acts*

It is very common for the assets of a large superannuation scheme to be managed as a segregated fund, rather than as part of a pooled fund comprising the assets of several schemes. There is an issue as to who is responsible for voting the equity investments of a segregated superannuation fund which employs an external investment manager: the scheme trustees or the fund manager?[109] Until the early 1990s, the great majority of fund-management agreements were silent on the matter of voting.[110] Voting was, nevertheless, presumed to be a matter for the fund manager in most such cases.[111] In late 1993, the AIMA formulated a standard investment-management agreement which expressly delegates the voting right to the fund manager, subject to any specific direction from the trustees.[112] The AIMA standard agreement was being adopted widely by mid-1994.[113]

There has, however, been some concern in Australia about whether trustees actually have the authority to delegate the voting right to the fund manager.[114] The concern stems from the narrowness of the powers of delegation contained in the State Trustee Acts.[115] In practice, this would be a real issue for only a very small minority of superannuation schemes if, as seems likely, the trustees of Australian superannuation schemes are given considerably greater powers in their trust deeds than by the relevant Trustee Act.[116] It is likely that the Australian scene is similar to that in the UK, where "[m]ost, if not all, modern pension scheme trust deeds contain wide powers for the appointment of advisers and agents. Further, trustees are given powers to delegate many of their functions such as investment management."[117] The AIMA was sufficiently worried about the situation that it made submissions to the State Attorneys-

108 Ibid.

109 In the case of superannuation schemes whose assets are invested in pooled funds, the voting rights attached to equity investments of the funds rest with the fund manager.

110 Finding of author's interview study.

111 Ibid.

112 AIMG, *Standard Investment Management Agreement and Commentary* (1993) AIMG, Sydney, cl 12.

113 Above n45 at 37–43.

114 This concern arose out of a paper prepared by Farrar for the AIMG: Farrar, J H, "Legal Restraints on Institutional Investor Involvement in Corporate Governance" (unpublished paper presented at the AIMG and Business Council of Australia conference on "Corporate Governance and Australian Competitiveness: The Role of Institutional Investors", Sydney, 11 November 1993).

115 See, eg, *Trustee Act* 1958 (Vic), s28; *Trustee Act* 1925 (NSW), s53.

116 The statutory powers and discretions conferred by the Trustee Acts are subject to any express provisions in the trust instrument: see, eg, *Trustee Act* 1958 (Vic), s2(3).

117 Quarrell, J J, *The Law of Pension Fund Investment* (1990) at 26. See also *Pensions Act* 1995 (UK), s34.

General — seeking the insertion of a wider delegatory power into the State Trustee Acts — and to the Insurance and Superannuation Commission — seeking clarification of the voting-right matter by way of either an amendment to the *Superannuation Industry (Supervision) Act* 1993 (Cth) or a regulation thereunder.[118] The approach of the AIMA would appear to mirror that of the UK's Goode Committee, which said in relation to the unsatisfactory delegation provisions in the *Trustee Act* 1925 (UK): although any "difficulties will be avoided by a properly drawn trust deed ... it [is] unsatisfactory for the law to be so unresponsive to the needs of modern fund management that it requires supplementation by scheme rules as a matter of course".[119] On those grounds, it is submitted that the State Trustee Acts should be amended to confer wider powers of delegation upon trustees.

F. *Minimum Notice Period for General Meetings*

Section 247(2) of the *Corporations Law* sets the minimum notice period for general meetings at just 14 days.[120] A general meeting convened with this minimum period of notice can present practical difficulties for some fund managers in regard to voting. Most companies' articles require that proxy forms reach the company at least 48 hours before the meeting.[121] This timeframe can be too short where a fund manager has to consult with, or obtain the blessing of, many external clients before voting. It is, however, unusual for the trustees of externally managed superannuation funds to either expressly retain the voting right or require that they be consulted before the fund manager votes. A 1994 survey of externally managed superannuation funds found that only 6.8 per cent of schemes' trustees either expressly retained the voting right or required the fund manager to consult with them before voting.[122] Nevertheless, some fund managers interviewed in 1994 complained of difficulties in lodging proxies within the period allowed, and a few said that the situation was compounded by the inefficiency of some custodians in forwarding notices, proxy forms, etc.[123] Increasing the minimum notice period in section 247(2) would have costs as well as benefits: some corporate deals require a speedy progression. However, an increase in the period to, say, the 21-day period specified in the Exposure Draft of the *Second Corporate Law Simplification Bill 1995*[124] would help to alleviate the voting difficulties faced by some

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118 See Pheasant, B, "Investors Seek Clear Proxy Law" *Australian Financial Review* 24 January 1994 at 19; Ries, I, "Chanticleer: Directors Face More Pressure" *Australian Financial Review* 11 February 1994 at 64.

119 Pension Law Review Committee, *Report: Pension Law Reform* (1993) HMSO, London, par 4.9.25. The UK position has been remedied with the enactment of s34 of the *Pensions Act* 1995 (UK).

120 Cf *Second Corporate Law Simplification Bill 1995 — Exposure Draft*, s249H(1), discussed below.

121 See, eg, *Corporations Law*, schedule 1, Table A, reg 55; see also *Corporations Law*, s248(1)(c); *Second Corporate Law Simplification Bill 1995 — Exposure Draft*, s250A(2), (3).

122 Only 4.1 per cent of schemes' trustees required the fund manager to act as directed by the trustees, whilst 2.7 percent required that they be consulted before the manager exercised the voting right. A further 5.4 per cent of schemes' trustees required the fund manager to advise them of any action taken: Association of Superannuation Funds of Australia Ltd (ASFA), *Corporate Governance Survey* (1994) ASFA, Sydney.

123 See above n45 at 135–43.

124 Section 249H(1).

fund managers, without reducing unduly the ability of company managements to take advantage of opportunities which require quick implementation.

G. *Restrictions on Size of Shareholding*

The larger an institution's shareholding in a particular company, the greater the incentive for the institution to engage in detailed monitoring at that company.[125] Therefore, regulations which restrict the ability of certain types of institution to take large equity stakes in companies are another form of legal disincentive to institutional monitoring. Section 401(2) of the *Corporations Law* prohibits an investment company (a closed-end fund) from holding more than five per cent of the issued ordinary shares of any company. Until late 1995, the prudential guidelines of the Reserve Bank of Australia had a similar import for Australian banks. Prior to December 1995, *Prudential Statement No G1* indicated that any bank proposing to take an equity stake of greater than 12.5 per cent in a company should refer the matter to the Reserve Bank. The *Statement* added: "A bank's equity associations with other institutions should normally be in the field of financial intermediation; involvements in non-financial areas should normally be of substantial relevance to banking operations." This clearly discouraged banks from holding equity in non-financial companies. And, as Table 2 shows, banks owned only a very small proportion of the listed Australian equity market at March 1995. It is notable that in other countries (particularly Germany and Japan), banks are important institutional shareholders.[126] It *may*[127] be significant, therefore, that in his *Innovate Australia* package released in December 1995, the then Prime Minister announced that, following a request from the Government to review its policy, the Reserve Bank had decided to liberalise its prudential guidelines to give banks "greater scope to make equity investments in non-financial businesses".[128] The change in government is unlikely to affect this development, as the coalition parties announced prior to the release of the *Innovate Australia* package that they believed that banks should have greater freedom to invest in equities.[129]

3. *Economic Barriers*

A. *The Structure of Corporate Ownership and Governance: Australian Institutions are Arm's-Length Investors*

There is a fundamental difference between the type of shareholder or shareholders which have ultimate control over quoted German and Japanese companies, and

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125 See below n147, and accompanying text.

126 It should, however, be noted that this is the case in Japan despite a legislative prohibition on any bank holding more than five per cent of the equity of a domestic company: above n7 at 1294. This seems to indicate either or both of the following: (a) the Reserve Bank's former clear preference for banks' equity holdings to be in financial, rather than non-financial, companies was of more significance than the 12.5 per cent "ceiling"; (b) economic disincentives largely explain the lack of interest by banks in taking equity stakes in listed Australian companies (see generally above n7).

127 Refer ibid.

128 Keating, P J, *Innovate Australia: Finance* (1995) at 7.

129 See Lewis, S, "Howard and Cook Row — Who Stole Whose Thunder?" *Australian Financial Review* 7 December 1995 at 4.

the type of shareholders which ultimately control the widely held Australian listed companies.[130] The ultimate controllers of German and Japanese firms are "committed" shareholders, whilst the ultimate controllers of widely held Australian companies are "arm's-length" shareholders.[131] This has a major ramification: when there are serious problems with the management of a widely held Australian company, the first instinct of many institutional shareholders is to try to extricate themselves from the situation by selling the shares. The dominant shareholders of German and Japanese companies, on the other hand, have a default strategy of staying put whilst a restructuring is conducted. In Japan, this often involves the "main bank".[132] In Germany, it occasionally involves the "house bank" (but not as often as in Japan),[133] sometimes involves the supervisory board, and sometimes involves no external intervention at all.[134] It is of some significance that the main/house bank typically has an equity holding in the company as well as a lender-borrower relationship with it.[135] In Coffee's terminology, the German and Japanese banks, and other committed shareholders, have traded liquidity for control.[136]

There is an important qualification to the above discussion, regarding monitoring in Japan and Germany. Some commentators believe that Japanese main banks, and German banks and supervisory boards, play an active role in routinely

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130 Equity shareholders are the "ultimate controllers" of public companies in Australia, Germany and Japan, since they have the power to vote the directors out of office. In relation to Australia, see *Corporations Law*, s227. In Germany, this ultimate control involves a two-step process, because German public companies have two-tier boards: a supervisory board and a management board. The two-step process is as follows. First, shareholders have statutory power to replace the shareholder representatives on the supervisory board before their term of appointment (usually five years) expires: see *Aktiengesetz*, s103. And, despite the fact that supervisory boards comprise both shareholder and employee representatives, the shareholder representatives control the supervisory board. This is the case because (a) in the case of public companies with less than 2000 employees, shareholder representatives constitute two-thirds of the supervisory board; and (b) in the case of public companies with more than 2000 employees, where there are equal numbers of shareholder and employee representatives, the chairman — who is always a shareholder representative — has a casting vote. The second step in the process is that the supervisory board can dismiss members of the management board before their term of office (usually five years) expires, provided that there is an "important reason": *Aktiengesetz*, s84(3). Important reasons include a serious neglect of duty; inability to conduct business in an orderly manner; or the withdrawal of confidence by the shareholders' general meeting: see Edwards, J S S and Fischer, K, *Banks, Finance and Investment in Germany* (1994) at 191.

131 See Stapledon, above n9, ch 9.

132 See, eg, Sheard, P, "The Main Bank System and Corporate Monitoring and Control in Japan" (1989) 11 *J Econ Behav & Org* 399 at 407–9.

133 See Edwards and Fischer, above n130 at 156–77.

134 See Mayer, C P, "The Functioning of the UK Financial System: What's Wrong with London?" (unpublished paper presented at the National Economic Development Office Policy Seminar on "Stimulating Innovation in Industry", Oxford, September 1991) (discussing an analysis by Franks and Mayer of 14 major restructurings of poorly performing German companies over the 1980s, which found that a majority of restructurings did not involve any outside intervention at all; only in cases of clear financial failure did the supervisory board intervene; usually the management board itself initiated the changes).

135 Since most shares in German companies are in bearer form, and are typically deposited for safe-keeping with banks, and since a corollary of deposit is the voting of the shares, the large German banks have an enormous amount of potential voting power: see Edwards and Fischer, above n130 at 111–5, 198–210.

136 Above n7.

monitoring the management of firms while performance is satisfactory. Kallfass, for example, states:

> Through the exercise of voting rights the big banks greatly influence hirings and firings in West German corporations' [non-]executive bodies, the supervisory boards; as well as on managing boards. They have a voice in all fundamental business decisions. This is evident not only from the high proportion of bank representatives on supervisory boards, but also from the frequent namings of bank managers as chairs of corporate supervisory boards.[137]

The latest evidence, however, supports strongly the view that, in normal states, the managers of Japanese and German firms have substantial discretion and leeway:

> In the normal course of events ... the [Japanese] main bank exercises explicit control neither in the selection of management nor in corporate policy making ... [Banks] remain as silent business partners in good profit states. Their power becomes visible only in bad states.[138]

> [T]he evidence for Germany shows only a weak relationship between bank proxy voting power and supervisory board representation ... In any case, there are several reasons to doubt the extent of control exerted by supervisory boards over the managers of [German public companies] ... [T]he available indirect evidence ... does not suggest that the supervisory board is in a position to subject German managers to a high degree of monitoring and control.[139]

It must be emphasised that, despite the problems associated with selling a large stake (resulting from the depressing effect upon the share price if it is not done with great caution), the author's interview study revealed that sale is still very much a major option for most institutions when serious problems emerge at an investee company. The nature of the outsider system of corporate ownership and governance means that, although the benefits from exit decrease as concentration of shareholding increases, exit will always be a reasonably attractive option. The outsider system seems, therefore, to have perpetuated the collective-action problem (associated with monitoring) during the period when increased institutional share ownership was increasing substantially the concentration of shareholding in Australia.[140]

Another effect of the outsider system, where institutions have the option of sale in the market or to a hostile bidder, is that even large institutions have only a fairly small number of fund managers and analysts available to perform detailed monitoring, and those persons each have only a relatively short time that they can devote to any one company.

B. *Collective-Action and Free-Rider Problems*

Once a company has more than one shareholder, the "collective-action" problem surfaces. The monitoring of management is a collective good: any positive effects from monitoring will be enjoyed by *all* shareholders regardless of whether or not

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137 Kallfass, H H, "The American Corporation and the Institutional Investor: Are There Lessons from Abroad?" [1988] *Columbia Business LR* 775 at 783.

138 Aoki, M, "Toward an Economic Model of the Japanese Firm" (1990) 28 *J Econ Literature* 1 at 14–5.

139 Edwards and Fischer, above n130 at 196–227.

140 The collective-action problem is discussed in the next Section.

they participate in, or contribute to, the monitoring.[141] For this reason, a shareholder behaving in an economically rational way will undertake monitoring only in limited circumstances. At the most basic level, it seems that a shareholder will provide the collective good of monitoring if the costs to that shareholder are outweighed by the benefits it receives from the monitoring.[142] However, as Rock points out, in the context of companies, the basic theory of collective action needs to be adjusted for the possibility of alternative courses of action: simply holding the shares (and free-riding on the monitoring efforts, if any, of others); selling the shares; or acquiring the company in a takeover or engineering a takeover bid for the company.[143] The crucial condition for the provision of monitoring is, as it happens, that the shareholder in question must stand to gain more from monitoring than from any alternative course of action.[144] If this condition is satisfied, then, in contrast to the basic theory of collective action, it is rational for a shareholder to perform monitoring *even if* the gains derived by that shareholder are exceeded by the cost of the monitoring. Also, and importantly, if a shareholder stands to gain more from an alternative course of action than from monitoring, then it is *not* in the shareholder's economic interests to perform any monitoring *even if* the shareholder would enjoy a net gain from monitoring.[145] The latter scenario can lead to a classic prisoners' dilemma, where (a) shareholders would gain collectively if each contributed to monitoring, but (b) it is in the interests of each shareholder not to contribute, so (c) no monitoring occurs and all shareholders are worse off than if they had all contributed.[146]

Of importance for present purposes is the fact that greater concentration of shareholding makes monitoring more rational for large shareholders for two reasons. First, it increases the benefits which flow from, and lowers the costs of, monitoring. Second, it decreases the benefits from alternative courses of action: free riding becomes less likely, and selling out becomes comparatively less attractive compared to monitoring.[147] The increase in institutional share ownership in Australia from the 1960s until the 1990s led to greater concentration in shareholding.[148] Why, then, do many fund managers still choose the option of selling the shares, rather than intervening, when serious managerial problems arise at an investee company?[149] It was suggested in the previous subsection that the nature of the outsider system of corporate ownership and governance means that, although the benefits from exit decrease as concentration of shareholding increases, exit will always be a reasonably attractive option. There are, however, other explanatory factors.

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141 See Clark, R C, *Corporate Law* (1986) at 389–400.

142 See Olson, M, *The Logic of Collective Action: Public Goods and the Theory of Groups* (2nd edn, 1971) at 23–4.

143 Rock, E B, "The Logic and (Uncertain) Significance of Institutional Shareholder Activism" (1991) 79 *Georgetown LJ* 445 at 455.

144 Ibid.

145 Id at 455–6.

146 Id at 456–7.

147 See id at 460–3, for a full explanation. In regard to the option of selling the shares, the outsider system of corporate ownership and governance ensures that this is rarely ruled out completely, regardless of the size of the institution's stake: see previous subsection.

148 See Ramsay and Blair, above n22 at 165–71.

149 Finding of author's interview study.

The discussion to this point has been based on the assumption that the ultimate beneficial owners (for example, the beneficiaries of superannuation schemes, and the unit-holders in unit trusts) of the institutions' equity holdings are the persons who decide whether or not to partake in monitoring.[150] In practice, of course, this decision is taken in most cases by the fund manager (external or in-house), and in some cases by the trustees (in the case of a superannuation scheme) or the board (in the case of an insurance company or investment company). Just as the divergence between the interests of shareholders and managers of a company gives rise to agency costs,[151] agency costs also arise from divergences between the interests of (a) a fund manager and its external clients (for example, the trustees of superannuation schemes and charities; private clients); (b) the manager and unit-holders of a unit trust; and (c) *some* of the trustees (namely the sponsor's representatives) and the body of members of an employer-sponsored superannuation scheme.[152] The agency problem in (c) has diminished as a result of the recent legislative requirement that members' representatives compose half of the trustee body of employer-sponsored superannuation schemes.[153] Problems (a) and (b) are, however, much more difficult to reduce to any great extent. The significance of the divergences detailed in (a) and (b) has been described as follows:

> Because of this divergence between the interests of [fund] managers and the interests of their principals, one cannot assume that because improving corporate governance may increase the value of the managed portfolios, improving corporate governance will be in the interests of the [fund] managers.[154]

As demonstrated in the next section, monitoring that increases the value of a company is a collective good for external fund managers.[155] On the other hand, the next four subsections show that only rarely will it be in the interests of individual fund-management firms to provide that collective good. The divergence between the interests of fund managers and their external clients means that the factors influencing whether it would be rational for a particular fund manager to engage in monitoring are different from those which would determine the rationality of monitoring if that decision were in the hands of that fund manager's clients. This suggests that less monitoring is performed by fund managers than is optimal from the point of view of their external clients.

C. *Assessment of Fund-Manager Performance*

In Australia, as in the UK and the US, the performance of a fund-management firm is measured *relatively* rather than *absolutely*. The asset-management consultants (mostly actuarial firms), which advise superannuation-fund trustees on the performance of their existing (and potential) fund managers, prepare "league tables" which rank investment managers according to comparative

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150 See above n143 at 464.

151 Jensen, M C and Meckling, W H, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure" (1976) 3 *J Fin Econ* 305.

152 See above n143 at 469–76; Coffee, above n23 at 843–6, 862–9.

153 *Superannuation Industry (Supervision) Act* 1993 (Cth), Part 9.

154 Above n143 at 473.

155 At this point the author's analysis departs from that of Rock: see below n159, and accompanying text.

performance. Similarly, the performance of unit trusts is assessed mostly in comparison to that of other unit trusts which have a similar class or classes of assets in their portfolios. Where a unit trust has an "Australian equities" brief, or a fund manager has a certain portion of its funds under management invested in Australian equities, then performance may be measured in comparison to a stock index (for example, the All Ordinaries Index). Therefore, where the holdings of each external fund manager with a stake in XYZ Ltd are index-weight, or near index-weight,[156] Rock says that monitoring "that benefits all will benefit none".[157] This is certainly the case in regard to benefit in the form of winning new clients through better relative performance. However, it disregards another benefit that a fund manager derives from an increase in the value of an investee company: almost all Australian investment managers charge their clients an ad valorem fee — a percentage of the value of funds managed. Therefore, any monitoring which increases the value of the funds under management also leads to an increase in the fund manager's fee. This is discussed further in the next section. For the moment it is enough to say that, where every external fund manager has an index-weight or near index-weight holding, even though it may be irrational for any one fund manager to provide the collective good (monitoring),[158] the fund managers as a group would be better off if the good were provided. It is at this point that the writer's analysis departs from that of Rock, who suspects that not monitoring is normally the collective good as far as external fund managers are concerned.[159] This is because Rock does *not* take into consideration the increase in fee that flows from an increase in the value of a portfolio company.

Once one relaxes the assumption that all external fund managers have an index-weight holding in XYZ Ltd, it becomes clear that some fund managers (namely, those with an overweight holding) have a greater incentive than others (namely, those with either an index-weight or an underweight holding) to engage in monitoring. Even though monitoring conducted by an overweighted fund manager would also benefit the performance of index-weighted and underweighted competitors, it would benefit the performance of the overweighted fund manager to a greater degree.[160] By the same token, an underweighted fund manager would probably never have an incentive to expend resources on

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156 A fund manager's "index" or "market" weighting in listed Australian equities is calculated as the market value of its total listed Australian equities under management divided by the market value of all listed Australian equities. The index weightings for the 25 largest managers of Australian equities at 31 December 1993 are set out in Stapledon, G P, "The Structure of Share Ownership and Control: The Potential for Institutional Investor Activism" (1995) 18 *UNSWLJ* 250 at 258. A holding larger than index-weight is an "overweight" holding; a holding smaller than index-weight is an "underweight" holding. A comparison of Tables 4 and 8 in Stapledon, id at 258, 272, reveals a considerable number of overweight institutional shareholdings in ASX All Ordinaries Index companies as at 1993.

157 Above n143 at 473–4.

158 It might, in fact, be rational for a fund manager to perform some monitoring: this would be so if its expected net gain from monitoring exceeded its expected gain from alternative courses of action: see above nn144–6, and accompanying text.

159 See above n143 at 474 (fn92), 476.

160 In theory, and disregarding for the moment the gain from an increased fee, only the fund manager which is *more* overweight in the company than any of its competitors (including those which also have overweight holdings) has the incentive to monitor.

monitoring. Any increase in its fee would be overridden by the cost in terms of having improved the performance of those competitors which had index-weight or overweight holdings even more than it improved its own performance — and possibly for no cost to those competitors! Interviews conducted (separately) by Coffee[161] and the present author have confirmed that UK-based fund managers do not participate in interventions when they have underweight holdings. The way in which the performance of external fund managers is assessed would appear, therefore, to contribute to less monitoring being performed by external fund managers than is optimal from the point of view of their clients.[162]

In-house superannuation-fund managers should not be affected by this consideration, because they are not competing for clients.[163] However, an in-house management team that consistently under-performs the industry's average manager may well be replaced by one or more external fund managers. An in-house manager with an underweight holding or even an index-weight holding may not, therefore, wish to take part in an intervention which, if successful, would improve the performance of other fund managers proportionally more than the performance of its own fund. This raises the question of whether other fund managers which have solely or predominantly internal funds under management — particularly the fund-management arms of insurance companies — are influenced by whether they are overweighted, underweighted, or market-weighted, when it comes to deciding whether or not to participate in an intervention. Certainly, from the point of view of the policyholders, an insurance company's fund managers should not take this matter into consideration.[164] But the executives of an insurance company want to win new policyholders, and there are many insurance companies in competition for potential new policyholders.[165] If an underweighted insurer (with, say, a one per

161 Reported in n24 above, at 2063-4. See also Jackson, P D, "Management of UK Equity Portfolios" (1987) 27 *Bank Eng Q Bull* 253 at 257.

162 External fund managers are major players in Australia. Five of the 10 largest managers of listed Australian equities at 31 December 1993 were firms which managed predominantly or solely external funds: above n156. At 30 June 1995, 66.5 per cent of the assets of Australian superannuation schemes (excluding those invested in the statutory funds of life offices) were managed externally: Australian Bureau of Statistics, *Assets of Superannuation Funds and Approved Deposit Funds, June Quarter 1995* (Catalogue No 5656.0) (1995) Tables 3, 3A, 3B.

163 Superannuation schemes operated by some of Australia's largest listed companies (eg BHP, CSR, and ICI Australia) employed in-house investment managers as at January 1996. In addition, at that time, State Superannuation Investment & Management Corporation was the in-house manager of the assets of the New South Wales government and semi-government superannuation funds; Queensland Investment Corporation was the internal investment manager of Queensland's public-sector superannuation funds and some other public-sector assets; and Commonwealth Funds Management Ltd was the in-house investment manager of the two main Commonwealth public-sector superannuation schemes.

164 There is every possibility, of course, that an insurer with an underweight holding would conclude that the likely financial benefit to its life funds from free-riding would exceed the likely benefit from contributing to the monitoring action. That would be a perfectly legitimate judgment from the point of view of the policyholders.

165 In addition, the fund-management arms of some insurers manage a considerable amount of external funds, and thus to a certain extent face the same disincentives as external fund managers.

cent holding) plays a major part in a successful intervention which improves the performance of its No 1 life fund for its existing policyholders, it might also be making a rod for its own back when the performance tables for insurers are next published. A rival insurer with an overweight holding (say six per cent) would, whether or not it also took part in the intervention, have achieved a gross return relatively greater (500 per cent greater, in this example) than that of the underweighted insurer.

D. *Financial Constraints*

Any form of monitoring involves costs for the fund manager(s) concerned. A major intervention obviously entails greater costs than less vigorous monitoring actions. Apart from the actual outlays involved in a major intervention, there is a substantial opportunity cost: the time spent by senior fund managers in organising and conducting the intervention:

> [W]hen investors are so concerned that they are seeking to constrain or reduce the actual or sought after power of one or more of the incumbent [directors], much more than a quiet chat is involved. ... There will be meetings with [executives of] the company, with its directors, with fellow shareholders, with professional consultants, with directorial candidates, and of course the mandatory 'no comment' to the press.[166]

Due to their seriousness, interventions inevitably involve the most senior fund managers at the intervening institutions. Indeed, the Deputy Managing Director of AMP Investments Australia Ltd said recently: "In the more public proactive issues, it is not unusual for a whole raft of very senior people in the investment institution to be involved, including not just the investment manager, but the chief executive, the chairman and often the board."[167] The opportunity cost is obvious: when tied up in an intervention at one investee company, the institution's senior personnel lose the chance to get on with other business, including marketing the firm to potential clients, and consolidating relationships with existing clients.[168]

There are numerous outlays involved in a major intervention. Legal fees would virtually always be a considerable expense, as it is standard practice for the advice of solicitors to be obtained. Other advisers, such as investment banks and recruitment specialists, are sometimes also engaged. If the matter gets to the stage of an extraordinary general meeting, there is the expense of an explanatory circular to all shareholders — a right which the intervening institutions would invariably wish to utilise.[169] If the intervening institutions

166 Hall, L, "Corporate Governance — Who Gains, Who Pays?" (unpublished paper presented at the ASFA National Conference, Melbourne, 3 November 1995).

167 Ibid.

168 Above n24 at 2059.

169 See *Corporations Law*, s252(1)(e) (see also *Second Corporate Law Simplification Bill 1995 — Exposure Draft*, ss249N, 249P, 249Q). Note that the company must bear the cost of actually convening the meeting requisitioned by the intervening institutions: s246(1). The notice convening the meeting would probably state only in brief terms the requisitionists' proposals (see *Corporations Law*, schedule 1, Table A, reg 41(1)), and therefore the circular is important as a means of explaining the case for replacing the director(s). If the directors fail to convene a meeting after having been requisitioned to do so, the requisitioning institutions can convene one (s246(3)), and the company must reimburse the requisitionists

send out their circular themselves, they must bear the cost of that. They are entitled to have the company circulate it for them.[170] In the latter case, the intervening institutions would have to pay (up front)[171] the company's expenses, but these can be reimbursed if the general meeting so resolves[172] (which it would probably do if the institutions had the numbers to implement successfully their other resolutions at the meeting).

It is very important to bear in mind that external fund managers cannot, in practice, "pass on" the costs incurred in carrying out detailed monitoring actions. It is a direct consequence of the highly competitive nature of the fund-management industry in Australia, the UK, and the US that external fund managers simply do not bother to ask their clients for a contribution towards expenses incurred in an intervention.[173]

> The not inconsiderable cost of being involved in a corporate governance action comes out of the [external] investment manager's return. It is a direct reduction of his or her profit. While the benefit of the action will go to the clients, the cost is borne by the manager.[174]

How does this affect the amount of detailed monitoring performed by external fund managers? The following scenario is based upon an example given by Black and Coffee,[175] but with an Australian company substituted for a UK company. Assume that an external fund manager holds one per cent of the shares of a listed company with a market capitalisation of $1,000 million. As this stake is worth $10 million, a proposed intervention thought likely to increase the company's share price by 10 per cent would yield the fund manager's clients (collectively) a $1 million gain.[176] Disregarding the problem of factoring in the probability of success of the intervention, it would almost certainly be in the interests of the fund manager's clients for the fund manager to contribute $20 000 towards the cost of an intervention[177] (assuming total intervention costs of $60 000 and three investment-management firms sharing the bill).[178] However, it was mentioned earlier that Australian, UK, and US fund managers charge their clients an ad valorem fee (a percentage of the value of funds managed, with the percentage decreasing the larger the fund). Table 4 sets out the average fund-management fees in Australia for four different

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out of remuneration or fees payable to the defaulting directors: s246(6). See also *Second Corporate Law Simplification Bill 1995 — Exposure Draft*, ss249D, 249E.

170 *Corporations Law*, s252(1)(e). See also *Second Corporate Law Simplification Bill 1995 — Exposure Draft*, ss249N, 249P, 249Q.

171 *Corporations Law*, s252(5)(b). See also *Second Corporate Law Simplification Bill 1995 — Exposure Draft*, ss249P(3)(b), (4); 249Q(7)(b), (8).

172 *Corporations Law*, s252(1). See also *Second Corporate Law Simplification Bill 1995 — Exposure Draft*, ss249P(4), 249Q(8).

173 Above n24 at 2058; finding of author's interview project.

174 Above n166.

175 Above n24 at 2057.

176 It should be noted that actuarial valuations of superannuation funds are, generally, based on current income and expected future income from investments held, rather than on the market value of the investments.

177 Recall, however, that the anticipated gain from monitoring must exceed the anticipated gain from other options: above nn144–6, and accompanying text.

178 Both of the most recent interventions in Australia (at Goodman Fielder and Coles Myer) involved three institutions playing a pro-active role (see above nn12–3).

types of management method, as at late 1995. Assume that each of the clients of the fund manager in the above example: (a) was a wholesale client (for example, the trustees of a superannuation scheme); (b) had placed with the fund manager a fund in the $5–10 million bracket; and (c) had engaged the fund manager to invest their assets in a pooled fund managed with a balanced brief. These assumed facts take us to the second row of the first column in Table 4. The fund-management fee would thus be 66 basis points (that is, 0.66 of one per cent). The expected $1 million increase in the value of the shareholding in the example would yield the fund manager an increase in remuneration of only $6600. In most situations, it would not be in the interests of the fund manager to contribute the hypothetical $20 000 towards the costs of an intervention.[179]

Table 4

Average fund-management fees, Australia: 1995

Size of client's fund ($million)	Average fee[a] for different management methods (% per annum of fund under management)			
	Pooled/ balanced[b]	Segregated/ balanced[c]	Pooled/ Aust Eq[d]	Segregated/ Aust Eq[e]
$0 < \chi \leq 5$	0.67	0.78	0.67	0.75
$5 < \chi \leq 10$	0.66	0.67	0.66	0.66
$10 < \chi \leq 50$	0.63	0.61	0.63	0.57
$50 < \chi \leq 100$	0.62	0.56	0.62	0.51
$\chi > 100$	0.61	0.54	0.61	0.45

Source: Information provided to the author by J L Addison, Authorised Representative and Manager, Investment Consulting, Sedgwick Noble Lowndes Ltd, Melbourne.

a Includes trustee fees as well as management fees, where applicable.

b Wholesale pooled funds, managed with a "balanced" brief. (A balanced brief is an investment mandate which allows the fund manager to invest the clients' funds across a range of asset classes — typically: Australian equities, overseas equities, Australian fixed interest, overseas fixed interest, real property, and cash.)

c Segregated (individually managed) funds, managed with a "balanced" brief.

d Wholesale pooled funds, managed with a specialist "Australian equities" brief.

e Segregated (individually managed) funds, managed with a specialist "Australian equities" brief.

The above example involved a company capitalised at $1000 million, which would have placed the company just outside the top 50 listed Australian companies as at 31 December 1995. It can be seen that the smaller the company, the larger the shareholding (or the larger the resultant increase in share price or both) would have to be in order that a fund manager's fee would increase by a constant amount as a result of an intervention.

The way in which external fund managers are remunerated would seem, therefore, to contribute to less monitoring being performed by external fund managers than is optimal from the perspective of their clients.

Managers of internal funds, such as fund-management arms of insurance companies and in-house managers of superannuation funds, would not have the disincentive just described. For them, the relevant consideration for present

179 See, however, above nn144–6, and accompanying text.

purposes would be whether an intervention would be likely to be cost-effective from the point of view of their fund(s).[180] On the other hand, they do not seem to be entirely free from the agency problem set out in the previous subsection.[181]

E. *Increased Level of Indexed Investing*

There has been a strong trend for many years in the US towards passive fund-management techniques. A passive fund manager holds index-weight stakes in a wide spread of companies, usually the constituents of a stock index such as the ASX All Ordinaries Index. Passive management techniques have been gaining in popularity in Australia during the 1990s, although it is fair to say that active management (also known as "stock-picking") is still by far the dominant method. Nevertheless, an increase in the use of indexing can be expected to exacerbate the problems referred to in the previous two subsections. In the first instance, an indexer will not, by definition, have any significantly overweight holdings, and thus (especially if an external manager) will always face the disincentive of improving the relative performance of overweighted rivals if it considers intervening at an investee company. Second, the fees charged for managing funds passively are, naturally, much lower than for managing funds actively. The figures underlying the third column in Table 4 (wholesale pooled funds managed with a specialist "Australian equities" brief) show that the fee for managing an indexed fund was on average half the size of that for an actively managed fund. The fees for indexing are so low that it is considered unlikely that an external fund manager could ever recoup the expense of organising and implementing an intervention.

Consistent with this hypothesis, two external fund managers interviewed by the author, whose firms used indexing and quantitative management techniques, said that their institutions did not even have the meetings which most institutions have routinely with the senior management of investee companies, on the ground that they would hold the stock regardless of what the management had to say. As they were external fund managers, it would be a waste of money for them to expend resources on monitoring of any sort, let alone a detailed monitoring action such as an intervention. On the other hand, numerous US institutions (such as CalPERS) which index their equity investments have played a very active role in corporate governance. The distinction lies, though, in the fact that institutions such as CalPERS are dealing with in-house funds, not the funds of external clients.

F. *Conflicts of Interest*

Several US works have analysed in detail the conflicts of interest which serve to dissuade various types of institution from becoming involved actively in corporate governance.[182] The evidence suggests that many Australian institutions face similar conflicts.

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180 See also ibid.

181 See above nn163–5, and accompanying text.

182 See, eg, Black, above n23 at 595–607; Romano, R, "Public Pension Fund Activism in Corporate Governance Reconsidered" (1993) 93 *Columbia LR* 795. For empirical studies, see Brickley, J A, Lease, R C and Smith, C W, "Ownership Structure and Voting on Antitake-

Most large Australian fund-management firms are affiliated with firms that provide services (besides fund management) to quoted companies. These firms may incur "private costs"[183] from being involved in an intervention or other form of detailed monitoring action, especially if the detailed monitoring takes place at a company with which other relationships exist. If a fund manager intervenes at XYZ Ltd, then XYZ Ltd might take business away from another arm of the fund manager's firm (for example, commercial banking, investment banking, corporate advisory, stockbroking, or commercial insurance), or it may take business away from the fund manager itself where the fund manager manages assets for XYZ Ltd's superannuation scheme.[184] However, business may also be lost by both a fund-management firm and its affiliates even where they have no relationship (other than the fund manager's shareholding) with the company subject to the intervention. Such a loss of business could occur as a result of the fund manager gaining a "bad" reputation amongst corporate managements — that is, the reputation of being an "interventionist". Corporate managements may switch business to more "loyal" financial firms. The fund manager may also find that the managements of other investee companies start to "clam up".

The potential for a conflict of interest to stymie activism by an institutional shareholder arose in a slightly different manner when the Bond Corporation group was trying to gain control of the board of Bell Resources in 1988. The AMP and several other institutions were concerned about the possibility of Bond Corporation trying to use Bell's large cash reserves for Bond Corporation's own purposes. The institutions attempted, first, to persuade the late Robert Holmes a Court to remain on the board of Bell. When this was unsuccessful, the institutions attempted, also unsuccessfully, to have an AMP representative appointed to the board of Bell. A senior executive of AMP "later revealed to the Australian Broadcasting Tribunal [that] Alan Bond, who then owned Channel 9, threatened [AMP] with negative television if AMP didn't stop complaining".[185]

In the course of the Coles Myer intervention in 1995, allegations were made that a senior trade-union official, who was said to be a friend of the impugned chairman of Coles Myer, had intimated to one of the intervening institutions that, unless that institution stopped intervening, it risked having union superannuation funds withdrawn from its management. The allegations were denied strenuously.[186]

Due to the existence of "reputational" conflicts of interest, there is generally less risk in monitoring in private compared to monitoring in the public arena. This explains partially the preference of Australian fund managers for

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over Amendments" (1988) 20 *J Fin Econ* 267; Brickley, J A, Lease, R C and Smith, C W, "Corporate Voting: Evidence from Charter Amendment Proposals" (1994) 1 *J Corp Fin* 5.

183 Above n143 at 460.

184 Interestingly, one of Australia's largest institutional investors, the MLC insurance group (owned by Lend Lease Corporation Ltd), advertised in 1994 that "more than 30 of Australia's top 50 companies [had] invested employee superannuation funds with the MLC Group": Advertisement *Australian Financial Review* 2 March 1994 at 41.

185 Hewett, above n11.

186 See Dore, C and Gluyas, R, "Questions Raised on Coles, Kelty and AMP" *Australian* 18 October 1995 at 1.

detailed monitoring to occur "behind closed doors".[187] It also explains the role played by the AIMA in the News Corporation "super voting shares" matter of 1993,[188] and in the Coles Myer affair of 1995. Many institutions which were opposed to the proposal by News Corporation Ltd to issue shares with "super" voting rights, and which favoured a restructuring of the board of Coles Myer Ltd in the aftermath of the "Yannon affair", were able to have their views made clear to the companies concerned without prejudicing other business interests — by using the AIMA as a spokesperson. As one fund manager has put it, the AIMA "can say things publicly without fear of commercial vendetta".[189]

Despite these possibilities, it is clear that the fund-management arms of some investment-banking firms have been involved in interventions in Australia. For example, BT Funds Management Ltd, the fund-management arm of the investment-banking group, BT Australia Ltd, was one of three institutions which were pro-active in the Goodman Fielder and Coles Myer matters.[190] Of particular interest is the fact that BT Australia was actually a corporate adviser to Goodman Fielder prior to, and during, the intervention by BT Funds Management and others, in 1994.[191] BT Funds Management held 6.1 per cent of the equity of Goodman Fielder at the time of the intervention,[192] which was well above BT's index-weighting (2.22 per cent at the end of 1993).[193] When a large, relatively illiquid, stake is held, the possible private costs (and other costs) to an institution of intervening may be outweighed by the potential benefits from installing new directors.

The AIMA has addressed directly the issue of conflicts of interest. Its corporate governance guidelines recommend that AIMA members should have a written policy on the exercising of voting rights.[194] The guidelines continue:

> Each investment manager's proxy voting policy and procedures should include a statement recognising that the investment manager must only vote in the client's interest, and that it is the investment manager's duty to put any other client relationship or interest to one side when deciding how to vote on behalf of clients .... It is recommended that ... the investment manager should report back to the client when votes are cast (including abstentions) on investments owned by the client .... [T]he report should include a positive statement that the investment manager has complied with its obligation to exercise voting rights in the client's interests only. If an investment manager

187 The author's interview project indicated that private rather than public interventions are the preference of a significant majority of major Australian fund managers. The preference for intervention to occur in this way is also explicable by the potential for damage to a company's share price as a result of a public brawl between its board and main institutional shareholders.

188 See Fridman, S, "The News Corporation Super Shares Proposal: Crime of the Century or Tempest in a Teapot" (1994) 4 *AJ Corp L* 184.

189 Hewett, above n11.

190 Above nn12–3.

191 Weatherdon, R, "Goodman Quit Threat Firm" *Age* 22 August 1994 at 30.

192 Syvret, P, "Chairman May Go in Goodman Shake-up" *Australian Financial Review* 5 August 1994 at 31.

193 Above n156.

194 AIMA, *Corporate Governance: A Guide for Investment Managers and a Statement of Recommended Corporate Practice* (1995) AIMA, Sydney, par 2.3.

is unable to make this statement without qualification, the report should include an explanation.[195]

There have been instances in the US where senior executives of a listed corporation, acting in their capacity as trustees of the corporation's pension scheme, have applied pressure to the scheme's external fund manager(s) to take a pro-management approach to the voting of equity investments.[196] It is unclear whether any (management-appointed) trustees of Australian superannuation funds have taken such action. In any event, the potential for this conflict of interest to materialise would have diminished significantly with the recent move by the legislature to provide for compulsory equal representation of employers *and members* amongst the trustees (or on the board of the corporate trustee) of employer-sponsored superannuation funds.[197]

4. *Practical and Political Barriers*

A. *Informational Constraints*

Fund managers with shareholdings in a particular company would, obviously, have access to far less information about the company than would the company's senior management. For current purposes, this informational disadvantage has an impact at two stages. First, a fund manager needs information in order to assess whether or not to undertake detailed monitoring. Several UK-based fund managers interviewed by the author pointed out that, in many instances, by the time the full extent of "bad news" comes to the notice of institutional shareholders, it is too late to take anything less than drastic action. Second, once a fund manager, or a small group of fund managers, has decided (for example) to intervene at a particular company, a period ensues during which there is a battle between the impugned directors and the intervening fund managers to secure the support of other shareholders — institutional and non-institutional. The informational advantage held by the directors can be crucial at this stage.

Part of the reason for the existence of the informational barrier is that Australian institutions typically have information solely from their equity holdings. They do not benefit (as do German and Japanese banks) from other relationships besides that of an equity shareholder. Even where a fund-management firm is affiliated with a commercial bank which lends to the company in question, or with an investment-banking firm which provides financial-advisory or broking services to the company, any useful information possessed by the other divisions or subsidiaries would be (or should be) inaccessible due to Chinese Walls.[198]

Even if obtaining requisite information is not a problem, there are several other practical hurdles that may need to be overcome by an institution considering engaging in detailed monitoring at an investee company. An outline of three of these practical barriers follows.

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195 Id pars 2.3, 2.4.

196 See above n143 at 469–70 (fn80).

197 *Superannuation Industry (Supervision) Act* 1993 (Cth), Part 9.

198 See *Corporations Law*, s1002M.

B. Requirement to Consult Client Before Acting

A practical difficulty for a minority of institutions is a requirement to obtain the prior blessing of all or many clients before voting or taking other action in relation to controversial matters. However, as mentioned earlier,[199] it is unusual for the trustees of externally managed superannuation funds either expressly to retain the voting right or require that they be consulted before the fund manager votes. There is an important distinction here. On the one hand, proper accountability necessitates that a fund manager's clients be able, if they so wish, to direct the fund manager on the exercise of rights attached to shares managed on their behalf. On the other hand, though, in most cases efficiency would be maximised — and good corporate governance would be promoted — by the fund manager having discretion to act swiftly as it sees fit, because: (a) "[w]here a quick response is required, the investment manager is most likely to be best able to act";[200] (b) fund managers generally have greater expertise than their clients in regard to detailed company-specific issues; and (c) "the investment manager ... is usually free to buy or sell the holding with impunity and without reference [to the clients, and] [m]erely voting the stock would seem to be a much less drastic action than selling the complete holding".[201] An appropriate trade-off probably comprises an arrangement under which a fund manager must (i) *notify* its clients of any serious intervention at, or proposed controversial vote at a general meeting of, an investee company; and (ii) act in accordance with any directions which the client *might* give.

C. Logistical Constraints

There are logistical problems which add to the expected cost of a planned intervention. In combination with other factors, they could deter some possible actions from taking place. They certainly hinder those interventions which do occur. Getting a group of just three or four institutions together for meetings at a mutually convenient time, at short notice, is difficult. This is one of the reasons why coalitions larger than three or four members become unwieldy.[202] This is a problem in Australia, where it would not be uncommon to find that half of the potential members of an institutional coalition are located in Sydney and the other half are located in Melbourne.

D. Lack of Homogeneity Amongst Institutional Viewpoints

As Farrar says, "institutional investors are by no means a monolithic group".[203] It is very common for disagreements to arise between different fund-management firms in regard to the need for, and the appropriate form of, detailed monitoring at a company in which each has a shareholding. In the Coles Myer case, there were even suggestions of "old Sydney versus Melbourne rivalries" amongst institutions.[204]

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199 Above n122, and accompanying text.

200 Above n166.

201 Ibid.

202 Above n156 at 251.

203 Above n114.

204 Hurst, J, "Hopes Fade for Coles Truce" *Australian Financial Review* 9 October 1995 at 20.

Lack of homogeneity in views can play a destabilising role at two stages. First, it can delay or prevent the formation of an institutional coalition. Secondly, where a coalition is in existence, it can either defeat altogether the goals of the coalition,[205] or lead to a more moderate outcome than that sought initially. Essentially, it is only when something is blatantly wrong that there will be sufficient like-minded institutions for a successful intervention to be possible. However, this does not appear to be a weakness peculiar to the Australian corporate-governance system. A similar situation exists in the UK and the US.[206] Also, interventions in Germany and Japan rarely occur until a late stage of under-performance.[207]

E. *Fear of Political Repercussions*

Australian institutions have some reason to fear political retaliation if they intervene "too often" or "too aggressively". A predecessor of section 1069(1)(k) of the *Corporations Law* (which limits the voting ability of unit-trust managers)[208] was introduced into the companies legislation in 1961. The Minister for Justice, speaking on the Bill, said:

> [T]he restrictions imposed by the Bill arise out of the necessity to impose some curb on the enormous power capable of being exercised, not by the interest holders themselves but by the managers of the [unit trust] who actually may have little financial interest in a particular trust.[209]

More recently, political intervention was reported to have occurred in the Coles Myer case.[210] The result of the institutional activism in that case — the resignation of two non-executive directors, the move of the impugned chairman to the position of vice-chairman, and the appointment of a new non-executive chairman and four new non-executive directors — was less profound than that sought by the pro-active institutions:

> Political pressure from the Prime Minister and other Labor figures forced senior fund managers into a compromise deal .... According to institutional sources angered at the limited scope of last week's board moves, Mr Keating's aggressive intervention against the institutional investors was crucial in forcing a compromise short of their preferred outcome.[211]

5. *Factors Which Precipitate Detailed Monitoring*

An interview study conducted by the author in the UK revealed four main factors which served to increase the propensity of UK institutions to intervene to

205 For example, in the Darrell James case, a non-coalition institution sided with the impugned directors, and helped to defeat the coalition institutions at the EGM: above n14.

206 Above n24; Stapledon, above n9.

207 See above nn137–9, and accompanying text.

208 See above nn103–8, and accompanying text.

209 The passage is set out in Harding, D, "Do Institutional Investors in Australia Have a Fiduciary Responsibility to Vote?" (unpublished paper presented at the Australian Investment Managers' Association and Institute of Corporate Managers, Secretaries and Administrators Ltd conference on "Proxy Voting", Sydney, 7 September 1994).

210 Above n13.

211 Hurst, J, "Revealed: How Keating Saved Solly Lew" *Australian Financial Review* 23 October

change the composition of a company's board: (a) unattractiveness of alternative strategies; (b) an overweight holding in the company; (c) fundamental soundness of the company's underlying business; and (d) deliberate misrepresentations by some of the directors.[212]

It would appear that some, and possibly all, of these factors have also had an influence upon the Australian institutions which have been involved in interventions. In relation to (a), it is fairly obvious why an institution would be more inclined to intervene when it considers itself "locked in" to a shareholding (that is, unable to dispose of the shares at a sensible price either in the market or to a takeover bidder) than at other times. The theory behind factor (b) was discussed earlier.[213] In the Goodman Fielder case, each of the three pro-active institutions had a significantly overweight holding,[214] but in the Coles Myer case AMP was approximately index-weighted, and the other two pro-active institutions were only slightly overweighted.[215] The Coles Myer case is analysed further, below. Where an external fund manager is concerned, factor (c) indicates a belief on the part of the fund manager that, with a better board, the company's share price would improve to such an extent that the costs of the intervention would be more than off-set by the anticipated increase in the fund manager's fees (which are based on the value of funds under management).[216] Finally, considerations other than purely financial ones may carry weight when factor (d) becomes a consideration.

Four further factors which have precipitated institutional activism in Australia are discernible from the Goodman Fielder,[217] Coles Myer,[218] and News Corp "super voting shares"[219] cases. First, in the News Corp and Coles Myer cases, large institutions were almost compelled to take action in order to save face domestically, because of immense media interest. Second, in the News Corp case, there was a feeling amongst prominent fund managers that the credibility of Australia's capital markets was at stake, given that institutional investors in other countries had championed the one-share, one-vote principle over recent years.[220] Third, the AIMA played a crucial role in each case. The News Corp matter arose only five months after the establishment of the AIMA's secretariat (it had operated for its first three years without permanent staff). The News Corp matter presented a perfect opportunity for the AIMA to "discover itself", and in both the News Corp case and the Coles Myer case institutions were able to use the AIMA as a spokesperson and thus avoid prejudicing their other business interests.[221] Fourth, in the Goodman Fielder case the intervening institutions were assisted (and apparently prompted) by

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1995 at 1.

212 See Stapledon, above n9, ch 5.

213 Above nn156–65, and accompanying text.

214 Above n192.

215 "Solomon Lew: For and Against" *Australian Financial Review* 17 October 1995 at 22.

216 See above nn173–80, and accompanying text.

217 Above n11.

218 Above n13.

219 Above n188.

220 Finding of author's interview study.

221 See above nn182–97, and accompanying text.

an individual shareholder who had a 3.5 per cent stake and was experienced in the food industry (Goodman Fielder's main area of operations).[222]

In addition to those four factors, it would be remiss not to mention the significance of AMP, Australia's largest institutional shareholder. The fund-management arm of AMP has played a leading role in most of the institutional interventions in Australia. Indeed, prior to the formation of the AIMA (known initially as the AIMG) in 1990, AMP was virtually the only Australian institutional investor promulgating standards of best practice in corporate governance. It has had an enormous presence in Australia's capital markets for many years, illustrated by the fact that its index weighting in listed Australian equities was about 4.4 per cent at the end of 1993 — which was double that of the next largest institution.[223] It appears that, at times, AMP's senior fund managers have almost felt that they were under a moral obligation to play a pro-active role. However, the ascent of the AIMA and the increase in competition in the Australian fund-management industry appear to have prompted a reconsideration by a senior executive of AMP Investments Australia:

> To date I have always strongly advocated that it was most appropriate for the concerned investment manager to be directly involved. However, in practice it will be the largest investors together with some public spirited parties who take the initiative. Perhaps some means can be evolved whereby the burden currently borne by these few can be more equitably shared. ... Given the difficulties and discomfort of being involved in a proactive action, there may be a case for having some other party or organisation take on that role.[224]

6. *Conclusion*

There are numerous disincentives to institutional activism in Australia, which can be categorised as legal, economic, practical, and political barriers. Some of the economic and legal barriers appear to be the most significant. The major economic barriers affect particularly fund managers with predominantly external assets under management. It would be only in rare circumstances that an external fund manager would stand to gain more from an intervention than from an alternative course of action. Nevertheless, during the first half of the 1990s there was a handful of high-profile institutional interventions at listed Australian companies. The article has highlighted several factors which arguably underlay at least some of those interventions. Any increase in the level of detailed monitoring in Australia is likely to be small, and explicable by the increasing level of institutional share ownership, and attendant increasing concentration of shareholding, occurring in Australia.[225]

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222 See also the Bennett & Fisher case: above n15.

223 Above n156.

224 Above n166.

225 See above nn147–8, and accompanying text.