Institutional Investor Proxy Voting
– Somewhere between compliance and enforcement.

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(Comment on this paper by conference attendees is invited
– as are requests for the supplementary notes)

ABSTRACT

The structure of capital markets is undergoing transformational change due to the increasing influence of superannuation derived investment activity. While the dispersed ownership model of the early twentieth century underpinned the development of agency theory - and the debate between shareholder primacy and stakeholder theory - current developments see a partial reversal of that model in the re-concentration of ownership via third-party manager/trustees.

Academic analysis of the impact on firm performance together with legislative barriers initially constrained the influence of this group, but the loosening of the regulatory restraints, and the re-targeting of the fund manager/trustee structure to enforce good governance, to encourage CSR-lead corporate strategy and to make effective precatory comment on executive compensation has emerged.

This paper looks at the current and potential opportunity available to fund managers/trustees for combining compliance and enforcement into a new force for higher standards of corporate governance in corporations of all sizes.

Part A INTRODUCTION

The theme for this conference poses both a puzzle and a challenge. The puzzle is that if Australia has the "most dense Corporations Act in the world" do we have – through its volume or in spite of it - either the best in the world or the most optimal for our Australian conditions. The challenge is to identify how appropriate corporate behaviour and disclosure can be achieved more effectively than by adding yet more pages to the Corporations Act.

There is a clue to both puzzle and challenge in the apparent opposites of "compliance and enforcement" – as one (compliance) suggests voluntary action, while the other explicitly refers to acts designed to impact behaviour by compulsion The thesis of this paper is that institutional investors can have a key role in addressing both the puzzle and the challenge - that might require components be added to (or amended within) the Corporations Act, but it is in the nexus of compliance and enforcement that resides most interest. Simply put institutional investors COULD be an alternative to more voluminous legislation. To achieve that outcome happily, however, requires a refined approach.

A major purpose in this paper is to suggest that there are in and around institutional investors…

(a) Opportunity for both voluntary and compulsory influences on corporate behaviour that might allow progression towards "appropriate" behaviour by the corporations in which they hold investment. (Discussed further in Part D)

(b) However for the institutional investors to address such opportunity will involve constraints, practicalities, conflicts and costs – some few have evaporated with time, others remain virulent. (Discussed further in Part E)

(c) At the same time, the definition of what corporate behaviour is to be influenced, and what could be called "appropriate", will involve a re-examination of the purpose of the corporate enterprise and a re-alignment of the fields of influence relevant to owners. (Discussed further in Part F).

Before we address these matters, we should discuss the nature and scope of the institutional investor sector and its challenges (Discussed further in Part B) and review the main themes of the literature (Discussed further in Part C)

Of the vehicles of influence on corporate behaviour and decisions, the use of shareholder/member votes cast in polls of members' meetings is central. Votes can be exercised by either meeting attendees or non-attendee shareholder/members via a proxy attendee. Assuming that the proxy attendee faithfully discharges their instructions, there is no material difference between the two voting processes and this paper will not limit its discussion to proxy voting and exclude voting by attendees. Indeed the decision to deliberately use the voting right is a separate issue to the manner in which it is counted in determining the poll outcome. In addition, while shareholder voting (including both proxy and attendee forms) is central, there are also other mechanisms of compulsion and persuasive influence that will attract some comment – allowing us to look at the complementarity of legislative and non-legislative issues, public and private intercessions, and precatory but credible encouragements versus obligatory directions.

The purpose of this paper is to provoke additional discussion on what reliance should be placed on institutional investors to achieve "appropriate" corporate behaviour, and the mechanisms best designed to realise that – as supplements to the statutory specifics of the Corporations Act.

Part B INSTITUTIONAL INVESTORS - SETTING THE SCOPE.

Three issues stand out

(a) "Institutional investors" is a term that can be applied to a fragmented collection of parties of very different characteristics, objectives and vulnerabilities to influence - from US union pension funds or Australian industry funds, to international hedge funds.[1]

(b) The total amount invested within this collective has grown, and will continue to grow. The numerical quantum of the sector brings a major structural implication - the amount of

[1] Some notes on the types of "institutional investors" and the structure of the sector will be available for distribution.

money that institutional investors have invested in listed equities is now so substantial that it puts to question the traditional Berle-Means "distributed ownership" paradigm.[2]

(c) However numerous and financially powerful institutional investors may be, their active intervention in the subjects of their investment activity can be examined along several quite different perspectives –

i) the reaction dimension - "exit/voice/loyalty",
ii) the strategic dimension - firm performance/corporate governance/socially responsible corporate strategy and behaviour
iii) the interaction dimension - public agenda items/proxy voting/private consultation and reputational influence.

Despite the variety of forms of institutional investors, there are some common elements – especially the idea that the task of investment is undertaken by one party for another in a manner that gives rise to a fiduciary responsibility[3]. Indeed, the question of both agency and fiduciary responsibilities can arise in a manner that is somewhat similar to that which applies between the managers and the owners of a corporate entity as that too involves an executive responsibility by one party to use resources provided by another party - both effectively and within limits acceptable to the provider of those funds.

The separation of ownership and control in the corporate entity was famously described by Berle and Means[4] in an exposition that was more than descriptive. It represented the development of this separation as an understandable if not inevitable outcome of two quite independent influences - the need for levels of capitalisation that was beyond the resources of single individuals and the necessity for the resultant executive operation of those entities to be focussed within a smaller group of professional specialists[5]. The outcome left the owners with a diminished level of control – arising largely from their dispersion.[6]

Around the time that Berle and Means were observing and explaining the new corporate structure, pension funds were often established by corporations for the exclusive benefit of their own employees[7]. It is to be expected that so long as pension funds are so structured, how ever

[2] Some notes on the size and growth of the institutional investor market will be available for distribution.

[3] A detailed description of the fiduciary and agency issues involved can be found in Paul U. Ali, Geof P. Stapledon and Martin Gold, *Corporate Governance and Investment Fiduciaries* (Lawbook Co, Sydney, 2003) including the various levels of responsibility and obligation between trustees and custodians that arise within the reality of the institutional investor market sector.

[4] Adolf Augustus Berle Jnr and Gardiner C. Means, *The Modern Corporation and Private Property* (Revised ed, Harcourt, Brace World, New York, 1968)

[5] It could be argued that the "Berle-Means phenomemon" was pre-ordained by the American legal and political environment rather than its economic development. See Bernard S. Black, 'Shareholder Passivity Reexamined' (1990) Vol 89 No 3 (Dec 1990) *Michigan Law Review* Pp 520ff and Joseph A. Grundfest, 'Subordination of American Capital' (1990) Vol 27 Iss 1 (September 1990) *Journal of Financial Economics* Pp 89ff

[6] *"It follows from all of the foregoing that the shareholder in the modern corporate situation has surrendered a set of definite rights for a set of indefinite expectations. (…) The stockholder is therefore left as a matter of law with little more than a loose expectation that a group of men, under a nominal duty to run the enterprise for his benefit and that of others like him, will actually observe this obligation."*

Berle and Means Op Cit – Page 244

[7] The first edition of "The Modern Corporation…" was published in 1932. In 1947 US Congress enacted legislation to prevent unions from setting up new pension plans (in effect closing them out of the possibility of an expanded position of influence) while interpretations of anti-trust legislation ensured that corporate pension funds held only

much they might wish to maximise the benefits of their members, they are unlikely to do so by confrontational intervention against the employer company. Similarly if they are fragmented – employer company by employer company - they are unlikely to embrace the pursuit of revolutionary change throughout the economy overall. So long as pension funds existed to attend to the retirement needs of the employees of a single entity, they were unlikely to be widely influential.

The primary influence of dispersal of ownership could be ameliorated if many owners collected themselves into a singularity. But that is not how "institutional investment" works. It works by first forming the singularity of the investor community and their investment resource, and then applying that to the acquisition of an interest in the entity. At the point of entry of their involvement with the corporation this group of investors are already a singularity. Subsequent to that, various institutional groups - sharing both the collectivist structure and some sympathy of purpose among themselves – might collaborate in various ways to make their work more efficient and to also leverage their combined potential influence. There are then two stages whereby the modern "institutional investor" sector contradicts the Berle-Means scenario. First the investors form a collective prior to investing in the entity, then, they can (to the varying degrees they wish) exponentiate their influence by collaborative action.

In doing all this however they set for us both positivist and normative tasks. In what manner do these institutional investors apply themselves to the corporate entities in which they hold an interest? What restraints on their influence are currently embedded in legislation, regulation and common practice? Is there evidence of their influence being used for good so that restraints should be loosened or should the restraints remain (or even be reinforced)?

Company law has – for many years – sought to protect the role of the directors from "inappropriate" interference by shareholder members. In most jurisdictions the management of the company is the preserve of the board of directors and there are some limitations on the interference in operational issues by shareholders – limitations either embedded in statutory measures or enforced by judicial precedent.[8]

Separate from shielding the directors, company law has – with varying clarity and determination – sought to protect shareholders from exploitation and abuse by their own number, and rather more recently recognised the risk of the majority acting prejudicially against the minority. Especially there have been, in more recent times, prohibitions on members from forming a covert alliance that would subsequently be activated to support a take-over of the enterprise.[9]

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fragmented holdings. See Mark J. Roe, 'The Modern Corporation and Private Pensions' (1993) Vol 41 (October 1993) *UCLA Law Review* Pp 75ff

[8] In the Australian jurisdiction, s 198A (1) of Corporations Act is a "replaceable rule" that proclaims "*the business of the company is to be managed by (…) the directors*." Courts have followed English cases such as *Automatic Self-Cleansing Filter Syndicate Ltd v Cunninghame* [1906] 2 Ch 34 and Australian cases such as *Howard Smith Ltd v Ampol Petroleum Ltd* (1974) 3 ALR 448. See Pamela Hanrahan, Ian Ramsay and Geof P. Stapledon, *Commercial Applications of Company Law* (8th edition ed, CCH Australia Ltd, Sydney, 2006) at para 5-340.

[9] The famous old English case of *Foss v Harbottle* (1843) 67 ER 189 set a narrow definition on the matters of dispute between shareholders and directors that the courts would consider as within its concern. More recently the Australian case of *Gambotto v WCP Ltd* (1995) 182 CLR 432 clearly defined that action of the majority of shareholders to ignore the wishes of the minority were not guaranteed the courts support. See generally H A J Ford,

That leaves us with yet another remaining and very complex set of issues – actions by managers, directors or other shareholders that breach their fiduciary responsibility, are self-serving or are ill-advised. In general, courts will intervene when they are satisfied that the actions show serious disregard for the rights of others. But are more constrained when actions are defensible – either in their intent and purpose or expected outcome. Courts are rarely a suitable recourse for actions of imperfect motive or marginal wisdom.[10]

Decisions that are commercially damaging but based on potentially valid, but actually misguided, commercial judgements might be excused under some sort of "Business Judgement rule". Either specifics in the relevant statute or judicial interpretations of the court's role based on precedent can prevent a dissident shareholder from obtaining relief in such circumstances.[11] Separately the question of balancing conflicting strategic priorities can introduce a similar but subtly different complexity. Here there can easily be a difference of opinion between management and shareholders and the consequent accusation put that management have betrayed their fiduciary responsibility by taken an approach to their policies and decisions that is at odds with the preferences of some shareholders based on qualitative considerations. Again there is some evidence that courts will prefer to avoid taking sides where possible.

So, while to some degree the law has limited its readiness to provide a court to hear disputes from dissident shareholders, what recourse do investors have other than through the courts? The most obvious reaction for a dissatisfied investor to take is the sale of its share holding in the subject of its dissatisfaction - be it called "exit" or "walk"[12]. It would be sad if the ONLY recourse that investors had to address their dissatisfaction with those entrusted with assets over which they have a claim is to sell out – and accept any losses that have arisen from past actions of those previously entrusted. In fact, there are opportunities for recourse through the courts if those entrusted with these assets of the corporation breach their fiduciary responsibility. However the nature of the alleged breach of fiduciary responsibility needs to be quite closely determined.

Institutional investors are – in turn – more liable to restraints on their use of the "exit" or "walk" options for addressing dissatisfaction than are most normal shareholders. First their shareholding could very well be of a scale that were it hastily or even progressively sold, that sale could have – of itself - a price depressing consequence. This phenomenon deserves more space that we can afford here - let us limit the discussion to the first level of hesitation – that an institution holding a significant number of a thinly traded stock may well conclude to "sit on their hands" if the level of dissatisfaction is moderate, and they fear selling will see the realised returns reduced by the market impact of their own actions.

R P Austin and Ian M. Ramsay, *Ford's Principles of Corporation Law* (LexisNexis Butterworths, Chatswood, NSW, 2005) at Chapter 11. In Australia the Corporations Act 2001 requires any party that has a "substantial holding" to disclose it – including "associates if they act in concert in relation to the affairs of another body corporate". See generally Phillip Lipton and Abe Herzberg, *Understanding Company Law* (13th ed, Lawbook Co, Sydney, 2006) at Chapter 18.

[10] Australian courts apply a "but for" test to determine if an impermissible purpose is causative – see *Whitehouse v carlton Hotel Pty Ltd* (1987) 5 ACLC 421 and Phillip Lipton and Abe Herzberg, *Understanding Company Law* (13th ed, Lawbook Co, Sydney, 2006) at s 13.2.75

[11] The Australian "Business Judgement" Rule is Corporations Act 2001 s 180(2). See Phillip Lipton and Abe Herzberg, *Understanding Company Law* (13th ed, Lawbook Co, Sydney, 2006) s 13.4.50

[12] The terminology – and the breadth of its potential use and significance - was spelled out in Albert O. Hirschman, *Exit, Voice and Loyalty: Responses to Decline in Firms, Organizations and States* (Harvard University Press, Cambridge, Mass, 1970) – see discussion on this subject in later Part C.

If however the institution needs to retain a “indexed balanced” totality to its investments it may well consider that disposal of all shares in any sector-dominant company is not an available option – without incurring a misbalance in the portfolio.[13]

It should be noted that the whole economics-based market expectation for listed stocks are disrupted in these scenarios. Ever since Adam Smith so eloquently summarised market forces into an “invisible hand” there has existed a presumption of the efficacy of market forces. But what we are seeing here is that the market is not free to react directly to actions that, while they could lead to market price fluctuations, are actions that the relevant participants are precluded from undertaking. Or put with similar but slightly different emphasis, the reactions of the market are not direct and simple but are influenced by a much greater complexity than “invisible hand” invitingly suggests. This market-defying influence is exacerbated as the volume of shares involved becomes greater. If it were that institutional investors held a large proportion of the major shares on issue, but felt constrained from trading them despite their dissatisfaction with their performance, the normal market mechanisms would be nullified.[14]

Much of the academic literature looks at the efficacy of institutional intervention on the basis of firm performance. Other parts of the literature contest the suitability of some measures - especially share-price and profit related measures - for assessing the significance of corporate governance specifics, but this is an issue we will not explore here.[15] While shareholder dissatisfaction may well be directed to firm performance – either on the basis of the profitability of the enterprise or its return to the shareholders – it is also possible that those same dissatisfactions are directed at changing the corporate governance of the entity, with no immediate concern with the impact on profitability or dividends. In this latter case, the objective of the influence is to achieve an end of corporate governance change, as opposed to achieving a means to subsequently achieve the end of improved firm performance via that governance change.

In setting the scope of this subject, it may be useful to clarify that these two different objectives (improving firm performance or achieving corporate governance reform) may require different methods – and hence incur different impediments to their success. But they may also introduce different assumptions and priorities as to the role of the corporation and hence the protection and obligations applied to it by corporate law, and the sort of interventions that corporate law might allow or prohibit shareholders from bringing to bear on the corporations in which they have an interest.

Instead of simply selling shares – and hence severing the association - one influence for corporate change that could be invoked is the voting agreement of the shareholders. Like the option to sell shares in a company in which one has lost confidence, the possibility of expressing a preferred

[13] The prevalence of index investing by institutional investors – as well as the theoretical underpinnings of then strategy is discussed in Paul U. Ali, Geof P. Stapledon and Martin Gold, *Corporate Governance and Investment Fiduciaries* (Lawbook Co, Sydney, 2003) in Chapter 4.
[14] The scope of this paper prevents this matter being fully discussed. The substanace is however simple. The principles of efficient market hypothesis – as expounded in Eugene F. Fama, 'Efficient Capital Markets: A Review of Theoretical and Empirical Work ' (1970) Vol 25 No 2 (May 1970) *Journal of Finance* Pp 383ff – cannot apply when major market participants are constrained from the buying and selling activity that they would undertake if were able to react to market pressures.
[15] Instead of listing relevant references here, readers are pointed to the literature review that forms Part C.

course of action for that company – for recommendation only or for compulsory adoption, by any individual shareholder or any group of shareholders of similar mind - is quite obvious. Interestingly however there are impracticalities that impinge on the availability of such a course of action. First, there is the right and the practicality of adding an agenda item that reflects the proposal to the Annual General Meeting. Second, there is the question of the distribution of some explanatory solicitation addressed to the other shareholders to explain and persuade of the proposal. Thirdly there is the impediments and complexities of convening a special meeting solely for the purpose addressing the matter – as opposed to including it within the annual general meeting agenda. So while a shareholder may wish to seek consensus with other shareholders on a particular proposal there are difficulties in the path of pursuing that ambition.

In addition to proposing resolutions from the shareholders that the directors might be forced or encouraged to adopt there is the separate but parallel matter of the election of the directors themselves. Typically, the corporate law leaves to the individual company decisions as to the number and qualities of directors, the duration of directors' appointments and the manner of their election. However if the directors are of a mind to protect their position they might seek to protect there appointment in a way quite opposite to that which shareholders might prefer. This can arise especially if the shareholders are of a mind to remove from office directors they adjudge ill-suited to the role, but whose continued appointment is considerable desirable by their director peers.

Without burdening this overview with specifics, the possibility of shareholders and directors taking a different evaluative position on a take-over proposal is a specific that can invoke considerable differences between the current directors and the current shareholders. This is another case in which the freedom of the market to resolve inefficiency is compromised. In theory, under-performing companies are taken over by more expert entities who are able to unlock additional profit from the underlying asset structure. However, entrenched directors and management can erect various structures to impede such a market movement – and defend their actions in so doing by arguing that the offer made is inadequate to the real value of the entity and hence that its acceptance defeats the longer term ambitions of the shareholders, private and institutional together.

Apart from selling shares, and seeking to influence the corporation by voting on matters of policy and implementation or election of directors, shareholders may also seek to influence the company by more private consultation. Private consultation between a single small investor and a major company in which he has invested is obviously impractical, but the possibility clearly exists of the more substantial investors enjoying the opportunity to have the ear of the company. This option seems – on the surface - to be an area that is ripe for exploitation by institutional investors if they take the view that such actions are economically justified and ethically sound. Indeed it is reported to be commonly employed and a preferred manner of pursuing an agenda for change by some institutions.

Clearly the practice of private consultation between an major investor and the subject of his investment invites concerns of conflict of interest and asymetrical disclosure – but it also presumes that when the investor speaks and exercises whatever leverage he can that he is suitably informed. While opinions on corporate governance matters might allow the investor suitable credibility, the management of the company should (at least in theory) be in a more informed

position on matters of corporate operation and the more general market issues that constitute the company's operating environment. It could well be then that having won the attention of the company in question, here now arise many ethical restraints on the institution use of its influence – restraints that could all be expressed as either legislative restrictions, or non-legislative principles and guidelines.

However, beside seeking endorsement from other shareholders and expressing a considered viewpoint to a company's senior management in private consultation, at least a third option exists for a stakeholder to pursue influence. The institution could resolve to avoid any suggestion of complicitous influence by publishing their opinions –and especially their negative opinions. The use of "focus lists" allows institutions to make public statement of criticism of corporate entities without covert consultation with the company in question and without requiring the support of other shareholders – but it too raises its own set of concerns. The transparency of the process whereby an institutional investor determines that is can publicly criticise the performance of corporate entities – either in its commercial and financial operations or its corporate governance – needs to be addressed if the practice is to be endorsed. Clearly both the validity of the criticism and its objectivity could be at question – as could the appropriateness of material being published in a way that un-sophisticated investors might react to ill advisedly. While public pronouncements of this sort avoid some of the issues involved with private consultation, they raise as many new ones if the practice is seen as approximating a vigilante-esque role for the institutions.

In recent years, there have developed a coterie of suppliers of information for institutional investors – especially of ratings of corporate governance performance by listed companies. On the one hand such a facility is an obvious efficiency as it allows the monitoring of companies to be done singularly and centrally instead of being duplicated at every investor's office. The problems that it raises are the questions of accuracy/validity and probity. In parallel to the establishment of these ratings services, bodies have been set up to encourage and support the interventionist activities of institutional investors. These parties seek to encourage the institutions to embrace within their duties an active participation in policing both the adequacy of the corporate governance structures of the companies in which they invest, and maintain a watching brief on any proposals that might be judged as a backward step. Especially they encourage institutions to actually use their voting power to register their opinions.[16]

Both information services providers and the collectivist proselytisers could be very effective vehicles for good – but could also introduce a new set of problems. While their opinions and services may be expert and informed they are another layer of agency in the structure.

The scope of our discussion here involves a substantial complex of issues. Some already have some legislative reference. Some allow influence to be brought to bear in a manner that is not currently the subject of legislative restraint but nevertheless raise questions of suitability. To render individual shareholders and especially institutional shareholders effective monitors of corporate performance will require unscrambling a knotty complex of issues.

[16] Notes on some of the main players in this area – vendors of corporate governance ratings, collectivist bodies and other consultancies, lobbyists and polemicists are available on request.

Part C HISTORICAL LITERATURE REVIEW

One of the earliest writings on institutional investors as potentials for corporate influence was the publishing in 1970 of Albert Hirschman's "Exit, Voice and Loyalty". He set his writings in a bigger context – embracing both customers and owners in the wider economic scenario of influencing institutions that suffer a behavioural "lapse". In summary, he put alongside the traditional economic mechanisms - such as supply and demand - the idea that exit and voice are of equivalent potential. His expression "exit/voice/loyalty" encapsulated an important set of wide-embracing and identifiably different alternative behaviours that were very widely applicable.[17]

Peter Drucker's 1976 book "Unseen Revolution" identified the trend towards an accelerating share of ownership of corporate America by the trustees of pension funds. Interestingly he saw this as a threat to the philosophical principles of capitalism as it implied such an enwidened level of corporate ownership that he referred to the phenomenon as "pension fund socialism" and extended the development that he observed to an outcome of making USA "the first truly socialist country". The conclusion Drucker reaches is that a new force will emerge to re-align the US political map. In fact the emphasis of his thesis is that new and revolutionary change will impact the American opinion and the political system – rather than express its influence through case-by-case influence on the corporations of America from which this newly identified power base derives its authority. He foresaw no hesitation in the pension funds eagerly embracing this role.

Drucker's contribution then was to add to the Hirschman's trio of economic influences, one specific influence of great potential dimension – an influence then apparently under-regarded but ripe for a significant role. [18]

Bernard Black has been a continuing contributor to the debate on the role of institutional investors as agents for change or influence in American business. Around 1991 he published a trio of articles that asserted that institutional investors were the only available force to counter the gravitational growth of corporate power into the hands of managers, but that there were major impediments to that single opportunity realising the task that Black saw before it.

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[17]Albert O. Hirschman, *Exit, Voice and Loyalty: Responses to Decline in Firms, Organizations and States* (Harvard University Press, Cambridge, Mass, 1970)

[18] Peter F. Drucker, *The Unseen Revolution: How Pension Fund Socialism Came to America* (Heinemann, London, 1976)

> *This new interest group has its own representative institution: the pension fund. Therefore, it has the means to organize itself for visibility, representation, and action. It has the organ through which it can make effective the controlling ownership of American business which it already holds. It has a "professional" representative in the "asset manager" and therefore access to the universities, the journalists, the opinion-makers, let alone the politicians. And the fact that this organ is quite different from the traditional organizations through which American interest-groups have reached such opinion- makers and decision-makers may actually make it more effective and more powerful. The "asset manager, precisely because he is a professional, is not a lobbyist (P 201.*

In "Agents Watching Agents: The Promise of Institutional Voice"[19] and "Institutional Investors and Corporate Governance: The Case for Institutional Voice"[20] he directs attention at the advisability of influence from institutional investors. The articles reference the Bearle and Means paradigm[21] but put beside it the idea that when large institutional investors emerge they redefine the relationships between ownership and management that distributed ownership seemed to predict with an axiomatic confidence. In turn, those relationships invite conclusions that require a reconsideration of the dynamics of corporate America. The assumption that distributed ownership inevitably disenfranchises small shareholders is thus put to question and the concept of "institutional voice" proposed. In "The Value of Institutional Investor Monitoring: The Empirical Evidence"[22] Black turns to existing published empirical research to conclude that (from a post 80's time frame) takeovers are an inadequate mechanism to resolve the corporate governance problem, but the existing shortfalls are all amenable to intervention by institutions and that continuing research and legal reform should pursue such an outcome.

Overall, much of Black's contribution to corporate governance writing is normative. He prefaces his discussion with the accusation of declining competitiveness of American business. He questions "if institutional oversight is *possible* (is it) *desirable"* and concludes that "(i)n economic terms, the *expected* benefit outweighs the *expected* cost"[23]. However the predictions that conclude the article are that while the argument for the desirability (and indeed practicality) of shareholder voice stands, there are considerable impediments to its realisation. In particular, the legal restrictions are nominated, the qualified incentives for investment institutions to embrace the role, and the premature assumption of their capacity to achieve meritorious change. In doing this Black introduces hesitations that some might say undermine his earlier assertion that institutional investor voice is a practical reforming influence.

The concluding comment summarises his considered debate – but also reveals the frustration that has stimulated it.

> *"The judgement here is that the upside from institutional voice is substantial and the downside is limited. Perhaps institutional shareholders can become skilled monitors of corporate managers. And perhaps not. But the current system leaves much to be desired, and we'll never know if there's a better way unless we try."*[24]

Black recognises then that there is a conflict between the theoretical validity of what he has been exploring and the practicalities of its implementation. At the same time, the problem that invites his analysis is the proclaimed failure of commercial competitiveness. In essence then, Black is seeking to apply the potential influence of institutional investors to improve firm performance –

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[19] Bernard S. Black, 'Agents Watching Agents: The Promise of Institutional Voice' (1991) Vol 39 *UCLA Law Review* Pp810

[20] Bernard S. Black, 'Institutional Investors and Corporate Governance: The Case for Institutional Voice' (1992) Vol 5 No 3 (Seas 3) *Journal of Applied Corporate Finance* Pp19ff

[21] Adolphe A Berle Jnr and G Means, *The Modern Corporation and Private Property* (1932)
It is judged unnecessary to describe or explain the main ideas captured in this publication – of such fundamental significance and very wide-spread appreciation.

[22] Bernard S. Black, 'The Value of Institutional Investor Monitoring: The Empirical Evidence' (1992) Vol 39 (1992) *UCLA Law Review* Pp895ff

[23] Black 1991 (op cit) at page 814

[24] Black 1991 (op cit) at page 888.

iby market-wide application. His conclusion is that there is theoretical validity for such but questionable practicality.

Black's subsequent articles express a more qualified optimism. In his chapter in the *"Palgrave Dictionary of Economics and Law"* (drafted in 1997)[25] he summarises thus…

> *A small number of American institutional investors (…) spend a trivial amount of money on overt activism efforts. They don't conduct proxy fights, and don't try to elect their own candidates to the board of directors. Legal rules, agency costs within their institutions, information costs, collective action problems and limited institutional competence are all plausible explanations for this relative lack of activity. The currently available evidence (…) is (…) that the institutions achieve the effects on firm performance that one might expect from this level of effort – not much."*[26]

Without assuming the role of Black's psychiatric counsellor, one could say that his later position represents a fairly pessimistic re-evaluation from that introduced in his earlier writings.

Black mainly writes from a US perspective, however his foray into the UK institutional investor/shareholder activism debate produced a similarly negative view of the subject – albeit with some qualifications. In 1997 Black provided a view of UK institutional investor intervention in his article "Hail Britannia?: Institutional Investor Behaviour under Limited Regulation"[27].

To leap to Black's conclusion is to do disservice to the thoughtful, informative analysis of the differences between UK and US situation that he draws out. In summary, he finds the UK institutional investor structure of larger market penetration, more privately communicative, and subject to less regulatory restraint. But overall, he finds the UK little more successfully interventionist than the US. However it is in the focus of their interventionist interest that is of most interest in this discussion.

Black asserts that corporate board structure is undergoing change in the UK – and cites the Cadbury Report as an important catalyst of the process. It could be said that the central recommendation of the Cadbury Report was an enhanced role for independent and/or non-executive directors. Black passes on to discuss the views of Florence (in 1961)[28] and Scott (in 1986)[29] who took issue with the applicability of the Berle-Means thesis in the UK where – compared to USA – shareholders were somewhat more concentrated and hence potentially capable of collective action. At least the assumption that high levels of distributed ownership apply and hence ownership and control are inevitably separated is questioned as overstatement.

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[25] Bernard S. Black, 'Shareholder Activism and Corporate Governance in the United States ' in P Newman (ed) *The New Palgrave Dictionary of Economics and the Law* (New York, NY : Stockton Press ; London : Macmillan Reference, 1997) Pp 459-465

[26] Black 1997 (op cit) – extract from the abstract of the piece.

[27] Bernard S. Black and John C Coffee, Jnr, 'Hail Brittania?: Institutional Investor Behavior under Limited Regulation ' (1997) Vol 92: 1997 *Michigan Law Review* Pp1997ff

[28] P. Sargant Florence, *The Logic of British and American Industry: A realist analysis of economic structure and government* (3rd ed, Routledge and Paul, London, 1972)

[29] John Scott, *Capitalist Property and Financial Power: A Comparative Study of Britain, the United States and Japan* (Wheatsheaf Books, Brighton, Sussex, 1986)

Black's earliest writings were focussed on firm performance. He asserted a problem of poor competitiveness, and he hoped for a minor revolution (while noting some impediments to it) that might allow improvement therein. His later writings deplore the failure of the revolution – and note (in passing) one particular international difference, that in the UK market the (then) current focus of change and the priority occupation was not on the outcome of firm performance but the underlying structural elements of corporate governance structure.

> *"We may be discovering, in the British experience, a different kind of inherent limit on shareholder monitoring of management – not the complete passivity announced by Berle and Means (…) but rather the reluctance of even large shareholders to intervene (…) (S)hareholder oversight of corporate managers will always be a matter of more or less and will need supplementation by other constraints. Installing a strong board is, no doubt, a central shareholder task, but it is no panacea: (…) (T)he British are far more concerned with getting their large institutions to pay attention to corporate governance than with stopping them from intervening too much."*[30]

In 1991 Edward B Rock published his paper on institutional shareholder activism[31]. Like Black he put his comments in the context of the (then) fashion of relying on independent directors to solve our corporate governance problems, but unlike Black he started from an expectation that there were dramatic developments in the institutional investor sector[32] but that the problem of economical activism – in the face of the obvious free-rider problem – was the issue to address. His conclusion is that the free-rider problem need not destroy the potential for effective institutional shareholder activism, but that the track record to date argues against that. His optimism for a future of more positive outcomes is loosely related to the potential for institutional activists to become a more committed alternative to the independent (and therefore uncommitted or minimally committed) director – arguably via shareholder representative committees.

Mark Roe has been a continuing contributor to the corporate governance debate. In the early 1990's Roe argued that financial institutions "had been regulated into passivity"[33]. That same year, John Coffee observed the "eclipsing (of) the hostile takeover as a mechanism of corporate accountability"[34] and questioned the efficiency and desirability of corporate monitoring through institutional investors, when the institutions themselves are content to be "rationally apathetic" because of the liquidity and control nexus. In contrast, Grundfest, Pound and Black all asserted

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[30] Black & Coffee 1997 (op cit) at page 2086

[31] Edward B. Rock, 'The Logic and (Uncertain) Significance of Institutional Shareholder Activism' (1991) Vol 79 (February 1991) *Georgetown Law Journal* Pp 445ff

[32] Rock 1991 (ibid) at Page 448

> "*(…) As at the end of 1988, the fifty largest money managers controlled (…) 27% of the total value of domestic equity. At least at first glance, these dramatic developments hold the promise of enormous changes in the nature of corporate law. As shareholdings become concentrated in fewer and more sophisticated hands, it is tempting to conclude that shareholders will finally be able to overcome one of the central problems that has pre-occupied corporate law for decades: the problem of collective action by shareholders"*

[33] The relevant Roe article is Mark J. Roe, 'A Political Theory of American Corporate Finance' (1991) Vol 91 (January 1991) *Columbia Law Review* Pp10ff however the quote is from John C Coffee, Jnr, 'Liquidity versus Control: the Institutional Investor as Corporate Monitor' (1991) Vol 91 (October 1991) *Columbia Law Review* Pp 1277ff

[34] John C Coffee, Jnr, 'Liquidity versus Control: the Institutional Investor as Corporate Monitor' (1991) Vol 91 (October 1991) *Columbia Law Review* Pp 1277ff at P 1279.

that statutory restraint around shareholder voting was constraining the monitoring function that the institutions were ready to perform. Coffee concludes that there are inadequate incentives for effective monitoring by institutions and calls for statutory reform not to remove restraint but to create market effective incentives for monitoring. He foresees a new paradigm in which institutional investors can unite liquidity (the "walk" option) and control to unlock their monitoring potential.

Roe's published views of 1990[35] and in 1991[36] were expressed more fully in his book of 1996[37] that explains the restraints on the power of owners of the corporation. He uses the term "atomistic" to describe the power-destroying fragmentation of ownership and his main emphasis is to explain how the legal restraints that limit the potential for influence by institutional investors can be explained by reference to political objectives that he can discern therein. His 2002 book[38] addresses a US/German/Japanese comparison – and especially explores the role of employees in corporate governance in addition to the role of shareholders - it is then peripheral to the concerns of this paper. But his earlier writings are important in re-affirming not only the circumstances that create a vacuum of control over corporate power, but the restraints on institutional investors using their collective strength to fill that vacuum.

> *Shareholder control of managers arises when the owner holds a large block of stock. Individuals rarely have enough money to buy big blocks. Institutional investors do. But law creates barriers to the institutions' taking big blocks. Banks, the institution with the most money, cannot own stock. Mutual funds generally cannot own control blocks of stock. Insurance companies can put only a fragment of their investment portfolio into the stock of any one company. Pension funds own stock, but they also face restrictions. More importantly, corporate managers control private pension funds, not the other way around. And we have just exhausted the major financial institutions in America; none can readily and without legal restraint control an industrial company. That is the first step of my argument: law prohibits or raises the cost of institutional influence in industrial companies.*[39]

As an intermediate summary of the corporate governance debate, Andrei Schliefer and Robert Vishny offered the "Survey of Corporate Governance" in 1997[40]. It would be fair to say that they saw their contribution as summarising the governance debate to that point in order to try to determine an overall direction that development change and constructive criticism should pursue. Especially they were concerned with the conflicting possibility created by legal restraint on the rights of larger shareholders, and the enhanced potential for influence that they have over the smaller investors. Large investors could well approximate the German and Japanese model as opposed to the American model – remembering that in the mid-nineties memories of the eighties

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[35] Mark J. Roe, 'Political and Legal Restraints on Ownership and Control of Public Companies ' (1990) Vol 27 (1990) *Journal of Financial Economics* Pp7-41

[36] Mark J. Roe, 'A Political Theory of American Corporate Finance' (1991) Vol 91 (January 1991) *Columbia Law Review* Pp10ff

[37] Mark J. Roe, *Strong Managers - Weak Owners: The Political Roots of American Corporate Finance* (Princeton University Press, 1996)

[38] Mark J. Roe, *Political Determinants of Corporate Governance* (Oxford University Press, New York, 2003)

[39] Roe 1991 (op cit) at page 11

[40] Andrei Shleifer and Robert W. Vishny, 'A Survey of Corporate Governance' (1997) Vol 52, No 2 (June 1997) *Journal of Finance* Pp 737ff

take-over activity in the American market was still fresh and hence the expected vitality of the "market for control" was strong. While it might be obvious that large investors and institutional investors are two different things, the potential for large institutional investors to make a major contribution is profound, in the opinion of Schliefer and Vishny, if we accept their summary assertion

> *"(…) (D)o large investors effectively expropriate other investors and stakeholders? Are they tough enough towards managers? Resistance to large investors has driven the evolution of corporate governance in the Unites States, yet they dominate corporate governance in other countries. We need to know a great deal more about these questions.*[41]

It is as if we have before us the vehicle for our salvation if only we can learn how to apply it. The same authors wrote in 1986[42] establishing that the major corporations in American have at least one major shareholder of around 15% and explored the influences that such a structure might have on corporate control negotiations.

Roberta Romano has been influencing the discussion on corporate governance since around 1989[43]. In 1993 she offered a generally pessimistic view[44] – she called it a "dose of reality" - of the potential for public pension fund activism due to the political influence applied by (especially state) legislative and gubernatorial pressures. In 1999 Romano made the nexus between institutional investors, shareholder activism and corporate governance in the US market quite explicit in a paper presented at a conference in Tilburg [45]. The view presented was consistent with her longer-term expressed position of criticising existing legislative restrictions on the opportunity for shareholder influence.

In 2000 her article "Less is More: Making Shareholder Activism a Valuable Mechanism" reported that institutional investor activism - such as it is – is ineffective

> *Shareholder proposals, although an increasingly prominent feature of institutional investor corporate governance activism since the mid-80s, have not had a significant impact on firm performance. The most plausible explanation for the absence of a discernible effect has been the large scale misdirection in the form that such activism has taken: many proposals have focussed on reforming board composition and structure and limiting executive compensation, yet empirical studies by financial economists of such reforms consistently indicate that they do not improve performance.*[46]

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[41] Shleifer & Vishny 1997 (op cit) at page 774

[42] Andrei Shleifer and Robert W. Vishny, 'Large Shareholders and Corporate Control ' (1986) Vol 94 (June 1986) *Journal of Political Economy* Pp 461ff

[43] Roberta Romano, 'Answering the Wrong Question: The Tenuous case for Mandatory Corporate Laws ' (1989) Vol89 No7 (Nov 1989) *Columbia Law Review* Pp1599-1617

[44] Roberta Romano, 'Public Pension Fund Activism in Corporate Governance Reconsidered ' (1993) Vol 93 No4 (May 1993) *Columbia Law Review* Pp795ff

[45] Roberta Romano, 'Less is More: Making Shareholder Activism a valuable Mechanism of Corporate Governance ' (2000) Yale Law School [Available from SSRN - abstract ID 218650] http//papers.ssrn.com/paper.taf?abstract_id=218650

[46] Idem at page 25

However in working towards her conclusion, she acknowledged that a balancing influence to the "agency cost" issue was active monitoring of management by institutional investors. A "damned if you do" and "damned if you don't" argument.

Stuart Gillan and Laura Starks[47] have provided a summary of the inter-relationship of corporate governance and institutional investors in their working paper of 2003. Their paper is much more positivist in stance as they trace the history of the debate from a Fama and Jensen/Meckling "Agency Theory" start point. Overall they avoid such strongly normative tones as used by either Black or Romano. Gillan and Starks also differentiate from those writers by deliberately seeking to establish an international perspective.

Corporate motivation can be difficult to define – and especially difficult to predict. An interesting – but only slightly relevant – contribution to the debate on institutional investor intervention comes in an article by Anand, Milne and Purda [48]. They looked at voluntary adoption of recommended corporate governance mechanism amongst Canadian firms, and determined that adoption was impeded by either a majority shareholder or an executive block holder. They found heightened adoption under certain conditions that lead them to conclude that it occurred when there was a likelihood of a future need for prospective investors. The idea that "recommended" corporate governance measures enhance a company's appeal to the market has been empirically established elsewhere. What is interesting here is the role of incentive to encourage adoption by those corporations that might otherwise be laggards. It could be extrapolated from Anand's proposition that a company that has no current intention to go to the market for further fundraising will allow its governance standards to slip – or fall into ineffective neglect. However the presence of a majority shareholder/block holder might actually impede the adoption of preferred corporate governance mechanisms.

Lucian Bebchuck has taken up the cudgels in a much more normative way by mounting an argument – across several articles across several years – that the rules need to be changed to facilitate more opportunity for activist shareholders to influence the strategic decisions of the board. His 2003 paper[49] was supportive of SEC changes to allow proselytising material for shareholder nominated directorial candidates to be included in proxy papers. Yet even in this paper his views were directed towards a greater empowerment of shareholders to influence the corporations in which they hold an equity interest.

In 2004 Bebchuck followed up with a longer article[50] that really set debate parameters for a wider discussion and one that continues apace. Here he extends his proposition from allowing material to be added to proxy papers to argue for the legislative amendments necessary for shareholders to be setting the "rules of the game" – by "reconsidering" the allocation of power between

[47] Stuart L. Gillan and Laura T. Starks, 'Corporate Governance, Corporate Ownership, and the Role of Institutional Investors: a Global Prespective' (2003) University of Delaware [Available from

[48] Anita Anand, Frank Milne and Lynnette Purda, 'Voluntary Adoption of Corporate Governance Mechanisms' (Paper presented at the 2006 Annual Meeting of American Law and Economics Association of Law Schools)

[49] Lucian Arye Bebchuck, 'The Case for Shareholder Access to the Ballot' (2003) Vol 59 (October 2003) *Business Lawyer* Pp43-66

[50] Lucian Arye Bebchuck, 'The Case for Increasing Shareholder Power' (2005) Vol 18 (January 2005) *Harvard Law Review* Pp833ff

management and shareholders so that shareholders can ultimately control all corporate “control” transactions – mergers and acquisitions “regardless of whether they are pursuer or target”[51].

This article lead to a three way debate between Bebchuck and two proponents of alternative views – Stephen Bainbridge and Leo Strine.[52]

Stephen Bainbridge’s views were initially developed for his 2003 article “Director Primacy: The Means and Ends of Corporate Governance”[53]. There he put the existing theories of the firm into a two axes model. It saw shareholder primacy and managerialism as the horizontal extremes of the “means” axis, with the rights of shareholders and the rights of stakeholders at the two vertical extremes of the “ends” axis. From there he confronts that model with the assertion that – in failing to recognise that neither shareholders nor stakeholders actually control corporations while indeed directors do – it fails to capture reality. He proposes a contractarian model that features the directors at the centre of radiating relationships – thereby avoiding reifying the firm from a conceptual to a practical role that it is too abstract to fulfil, yet retaining the essence of the contractarian view of the firm as a nexus of contracts.

Bainbridge’s 2003 discussion on the role of institutional investors is brief. He refers to Black’s “Shareholder Activism…” paper as he concludes…

> *“… (I)nstitutions expend little effort on monitoring management; to the contrary, they typically disclaim the ability or desire to decide company-specific policy questions.*[54]

In 2005[55] Bainbridge returned to the relevance of institutional investors to his theory of “Director Primacy”. Somewhat at odds with the conventional wisdom he opined that institutional investor activism undermines the role of the board of directors and hence will not solve the principal-agent problem. To him the theory of the firm leads one to appreciate a limited role for shareholder voting as a last resort accountability device – and indeed concludes that rational apathy is as prevalent amongst fund shareholders as it is amongst corporate shareholders.

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[51] This summary characterisation is actually offered in Leo E. Strine Jnr, 'Towards a True Corporate Republic: A Traditionalist Response to Lucian's Solution for Improving Corporate America' (2006) Harvard Law School [Available from Available at SSRN: http://ssrn.com/abstract=883720. Precisely, it is expressed thus

> *“Bebchuk also expresses the view that stockholders might be well-served by adopting rules of the game that prevent the board from acquiring other companies or assets without stockholder assent. Thus, Bebchuk hopes to give stockholders the tools to police overpriced acquisitions and acquisitions that conglomerate non-synergistic assets for the sake of aggrandizing management rather than increasing investor returns. Overall, shareholders, under Bebchuk’s system, would have the ability to establish rules of the game governing all corporate M&A transactions, regardless of whether the corporation was the pursuer or the target.”*

[52] Bebchuck’s contributions to this debate extend well beyond the articles cited thus far.

[53] Stephen M Bainbridge, 'Director Primacy: The Means and Ends of Corporate Governance' (2003) Vol 97 No 2 *Northwestern University Law Review* Pp547ff

[54] Bainbridge 2003 (op cit) at page 572

[55] Stephen M Bainbridge, 'Shareholder Activism and Institutional Investors ' (2005) UCLA School of Law [Available from

Then in 2006[56], when Bainbridge is writing in response to the Bebchuck's call for legislative reform to allow investor activism, does he take up the normative case for "director primacy" as a counter argument to what Bebchuck had proposed. In that discussion he forthrightly asserts that the problem of legislative restraint on shareholder influence in corporate governance is precisely what "director primacy" means.

Chancellor Strine of the Deleware judiciary has also provided a contrary view to Bebchuck's proposal[57]. It is the view of the "traditionalist" – and not surprisingly for a representative of the judiciary – it defends the existing legislative restraints. But while Strine raises criticism of Bebchuck's proposals, he actually offers alternatives that are sympathetic and – at least in Strine's expressed view – palatable to both the traditionalist legislator and a traditionalist judiciary.

Strine defends the status quo as "the empowerment of centralised management to make and pursue risky business decisions through diverse means"[58], "the ability to react adroitly to emerging developments and opportunities"[59], and "that there is a (recognised) difference between a bad result and a decision made in bad faith"[60]. By comparison, changing the mechanisms of influence for shareholders is "an over-reactive and poorly designed means to generate better corporate performance."[61] Strine's defence of the traditionalist view is optimistic and predicated on the broadest generalities. So long as the American corporate economy is strong, he is right. By comparison, so long as there are cases of corporate abuse by manager/directors who ill-serve shareholders, then Bebchuck is right that there is a problem to be solved and a necessity for some remedial action of the sort he proposes is justified.

Strine's assessment of the potential role for "institutional investors" to be mandated heavily in the debate of corporate strategy is almost invective. He accuses them of lacking a fiduciary duty to guide their actions, over-sensitivity to short-term (quarter-on-quarter) earnings, progenitors of destructive options-based executive remuneration, and liable to march to the drum of political-motivated causes of the moment. For the companies like ISS – providing advice on how to vote – Strine is scathing. He accuses them of being "even more unaccountable than their (…) clients"[62]. He links the failure of the institutional investors to "discern obvious rot"[63] at Enron with a priority for short term-ism that sets them apart from the "diversified investors" trying to "build wealth to send children to college and sustain themselves after retirement"[64]. In so far as Bebchuck's proposals empower such people, they a might as well empower Beelzebub himself.

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[56] Stephen M Bainbridge, 'Response to Increasing Shareholder Power: Director Primacy and Shareholder ' (2006) Vol 199 (April 2006) *Harvard Law Review* Pp1735ff

[57] Leo E. Strine Jnr, 'Towards a True Corporate Republic: A Traditionalist Response to Lucian's Solution for Improving Corporate America' (2006) Harvard Law School [Available from Available at SSRN: http://ssrn.com/abstract=883720

[58] Strine 2006 (op cit) at page 7 (as a discussion paper, pagination may vary – see Strines note 20.

[59] Strine 2006 (op cit) at page 7 after note 20

[60] Strine 2006 (op cit) at page 8 after note 20

[61] Strine 2006 (op cit) at page 9 near note 21

[62] Strine 2006 (op cit) at page 11 after note 26

[63] Strine 2006 (op cit) at page 12 after note 26

[64] Strine 2006 (op cit) at page 12 after note 26

The Australian academic debate on the role of institutional investors can be conveniently summarised as opening with Geof Stapledon's 1996 book "Institutional Shareholders and Corporate Governance"[65]. The book concentrates on two jurisdictions – UK and Australia - and provides some comparison comment on others, especially the US. But it is the fundamental assumption of Stapledon's work that there are problems that "institutional monitoring" can and should address and do so more expansively in the future. Stapledon is meticulous in tracing the size and characteristics of his subject market – and the differential characteristics amongst them. As far as the Australian market is concerned, Stapledon records that institutional shareholders are not so dominant in the other markets that he notes – but that inter-corporate and "founding-family" holdings occur more often.

Stapledon observes the absence of the sort of deleterious aspects of institutional intervention that Strine regrets (writing some years later). Stapledon finds their actions wide-ranging including both "procedural and general issues" as well as company-specific matters. However, Stapledon notes that intervention is limited to the very worst cases of sub-optimal performance. The reason for this marginalisation of the potential for across-the-board improvement is – he finds – the combination of weak incentive and string dis-incentive. In this his writings tailor with the sort of reservations about the potential for effective intervention that Bernard Black described and which were noted above.

In 1998 a paper was issued by the Centre for Corporate Law and securities Regulation at the University of Melbourne under the authorship of Ian Ramsay, Geof Stapledon and Kenneth Fong[66]. Entitled "Institutional Investors' Views of Corporate Governance" it was a document of quite different nature to most of those previously discussed as it reported the expressed opinions of some twelve institutional investors that had been interviewed about their views.

The major planks of sound corporate governance (independent directors, committees etc) were endorsed as desirable and sometimes preferences expressed for compulsion. Most institutions claimed to vote – and all except one claimed to have used their vote in opposition to management. All claimed to have "intervened" on a corporate governance issue. Most referred to the consultative/collaborative relationship with firms in which they invest. All institutions were aware of "problems" that might arise under insider trading restrictions and generally seemed aware of restraints on their monitoring activity but not totally prevented from pursuing it.

The authors of the report boldly confront the concept that, given the growth of their role to one of real substance in the equities market, the activist institutional shareholders can put the lie to the traditional Berle and Means "ownership and control" separation.

The most interesting thing that this report raises in the current context is the apparent willingness for the institutional investors to embrace an interventionist role, and to "just get on with it" – recognising that there were legislative restraints and risk but simply working their way around them. If such attitudes and conclusions are typical in the Australian environment they seem to vary markedly from the American academic and theoretical situation that has been the substance of the discussion above.

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[65] Geof P. Stapledon, *Institutional Shareholders and Corporate Governance* (Clarendon Press, Oxford, 1996)
[66] Ian Ramsay, Geof P. Stapledon and Kenneth Fong, *Institutional Investors' views on Corporate Governance*, Centre for Corporate Law and Securities Regulation (1998)

They also seem to presume a focus of interventionist energies on corporate governance issues and not on commercial "firm performance". Interestingly the text discussion of the report never raises any suggestion of such matters falling within the matters raised in interview nor captured in the report.

In 2003 Paul Ali – with Geof Stapledon and Martin Gold – published "Corporate Governance and Investment Fiduciaries"[67]. This volume is primarily concerned with a suitably complete explanation of the fiduciary elements of financial markets – based on a transactional analysis of the structure of that market. However the question of the interventionist role of institutional investors is not ignored. It is however written from the point of view of defining the legal obligations that fiduciaries face. Much of the writings discussed so far have been concerned with the constraints that limit the opportunity for effective interventionist actions and the wisdom of revising or removing those restraints. Ali and his co-authors discuss the appropriateness of a compulsory voting rule and conclude that is not a worthwhile reform. Much of Ali's discussion of institutional investor activism is predicated on Bernard Black's 1998 writings that have been discussed above and so will not be further re-presented here.

Part D THE PAST – AND CONSTRAINTS ON ACTION.

The early 1980's was a period of some turmoil in the US corporate market[68]. It was a "takeover rich" period that spawned a generally defensive reaction by management – by erecting protection against takeover through stronger defences or by avoiding them by management sponsored leveraged buyouts. It was, then, a period in which control of the corporation fell more into the hands the management and less to the shareholders – both the institutional and the small and dispersed. But notwithstanding, it was also a period of general awakening of the potential for influence by institutional investors – and simultaneously an increased awareness of the constraints that might limit their effective intervention.[69]

In 1987 CalPERS – a California based institutional investor of substantial size, and one later to emerge as one of the more activist - fought "poison-pill" resolutions at AMR Corporation and Aluminium Company of America, but after that switched its focus to more "performance based" influence.[70]

For our purposes, the late 80's and the early 90's provide a suitable start point at which to examine the constraints that have actually been at play in holding institutional investors back from taking a more assertive role.

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[67] Paul U. Ali, Geof P. Stapledon and Martin Gold, *Corporate Governance and Investment Fiduciaries* (Lawbook Co, Sydney, 2003)

[68] See generally Gordon Donaldson, 'The Corporate Restructuring of the 1980's - and its Import for the 1990's' in D H Chew Jnr and S L Gillan (eds), *Corporate Governance at the Crossroads: A Book of Readings* (McGraw-Hill Irwin, New York, 2005

[69] There is a time-line (of almost exclusively US) events available as a supplementary note that allows many of the events and developments referred in this paper to be clearly and simply seen.

[70] Claire E. Crutchley, Carl D. Hudson and Marlin R.H. Jensen, 'Shareholder Wealth Effects of CalPERS' Activism ' (1998) Vol 7 (1) *Financial Services Review* Pp 1ff

The term “monitoring” can be used to refer to both the information gathering/opinion forming process that precedes intervention - and also to refer to the accumulated process of both gathering information and the intervention involved in acting upon it. The argument that monitoring is a cost that invites “free-riders” is obvious, as is the consequent conclusion that both the direct cost of monitoring and the free-rider impact will undermine the potential for institutional investors to either alter the balance of corporate governance or directly intervene in poorly performing companies. At the same time, the amount of the monitoring cost and the size of the investment might make it viable notwithstanding that there is a free-rider issue. But the conundrum goes further - in 2002 Thomas Noe documented that strong interventionist activity by institutional investors often derives from quite small holdings.[71] If Noe’s conclusions are accepted, then it might appear that effective constraint of institutional intervention is not based on a financial analysis (or at least not entirely) but on some other set of issues – amongst which could conceivably be the attitudinal profile of the institution, and how it sees its role.

In 1989 T. Boone Pickens, the American activist shareholder and investor, established United Shareholders Association “to advocate the enhancement of shareholder rights and management accountability (…)”[72] . It was dissolved in 1993 but later – in 2002 David Manry and David Stangeland conducted an empirical study of the effectiveness of its “Shareholder 1000” list and found that firms ratings on the list correlated with both their financial and non-financial performance. The association’s declared aims – and its practices – included various lobbying and representational efforts deemed salutary for American business. It is interesting but inclusive that an activist shareholder should undertake this role, seemingly discharge it well, but then discontinue it after a comparatively short period. (It is suggested that the market became over-crowded.)[73] Just as interesting is the authors’ suggestion that their work addresses both the effectiveness of activist reporting and the correlation between good governance and firm performance. However what may well be hard to dispute is that by the early 90’s a model of some sort for interventionist actions – by institutions or non-institutional activist shareholders – was in place for others to emulate at their will.

The interventionist mechanisms that institutional investors have available to them are – fundamentally – three fold. They can walk, talk or suffer silently (also expressed as being loyal). The “walk” alternative (meaning to sell the investment) is an option only rarely efficacious in initiating change and often unavailable to institutional investors. We will pass over the “loyalty” option of suffering in silence, and turn to the “talk” option. It has in turn two broad alternatives. Investors can seek to effect change through voting activity and through other public statements of criticism and praise, or through private consultation and discussion. Taking a public posture of criticism, independently of any consultative discourse with the corporation, is really a fourth sub-type to add to “walk, talk or suffer”.

It is often suggested that the preference is for private consultation. Writing from the Australian perspective, Ian Ramsay with others – conducted and reported on an interview exercise in 1998 that established the preference for that method of resolving dissatisfaction with corporate

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[71] Thomas H Noe, 'Investor Activism and Financial Market Structure' (2002) Vol 15, No 1 (Spring 2002) *The Review of Financial Studies* Pp 289ff

[72] David Manry and David Stangeland, 'The United Shareholders Association Shareholder 1000 and Firm Performance ' (2003) Vol 9 No 3 (June 2003) *Journal of Corporate Finance* Pp 353ff

[73] Manry ibid – Note 17

“*It could also be argued that USA ceased operations prematurely. The Corporate Governance Network (2001)(…) currently indexes 31 organizations involved in shareholder rights issues (…)*”

performance as opposed to a public confrontation[74]. Similarly widespread was awareness of the possible risks of such activity. Two risks stand out. First there are the "shadow director" provisions. Second, the risk of insider trading breaches. In 2003 Paul Ali – with others including one involved in Ramsay's work - followed up with a more extensive exploration of the subject in his book.[75]

The risks that institutions face from private lobbying of investee companies can probably be avoided with a little care. The Australian "shadow director" risk arises if the board is "accustomed to act" in accordance with instructions – hence occasional contact is unlikely to trigger the risk.[76] The insider trading rules involve a little more. While they would seem to only arise if the institution "trades" – and can hence be circumvented fairly easily - the restriction on trading can in itself be a significant restraint for an active investing entity - especially if there are new float issues involved. The idea that "Chinese Walls" can keep information secret between different decision-making segments within an institution is probably better left as defence than cited as a continuing structural solution.

However the more compelling concerns with private consultation are the issues of the competence of the institution seeking to influence the corporation and the informational asymmetries that inevitably arise.

To address the competency issue first… In 2002 Robert Parrino, Richard Sias and Laura Starks published a fascinating empirical study[77] (they claim it to be the first) of the sale activity of stock by institutional investors around the time of forced CEO turnover. In this study we are focussed right in on the behaviour of institutional investors under a specific set of circumstances – based on a reasonably numerous (583 investee companies, 19,104 institutional shareholder positions) set of samples. Although there are four hypotheses tested, the issue of most interest here is the support for the conclusion that institutions are (in some cases) well informed, but in other cases apparently not. On average institutional investors reduce their holdings by 12% in the year preceding CEO turnover. However, while some 54.44% of institutional shareholdings were reduced, 45.14% actually INCREASED their shareholding. Although the question of CEO turnover indicating a poor performing company or indicting a re-energised one might be am interesting debate, the research tends to suggest that generally equivalent numbers of institutional investors interpret the company in diametrically opposed ways. The data seems to put doubt on the idea that the institutional investor sector consistently forms informed views of corporate performance. If that is valid, in turn that could reflect on the suitability of the sector publishing its "focus lists" of under performing stocks.

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[74] Ian Ramsay, Geof P. Stapledon and Kenneth Fong, *Institutional Investors' views on Corporate Governance*, Centre for Corporate Law and Securities Regulation (1998)

[75] Paul U. Ali, Geof P. Stapledon and Martin Gold, *Corporate Governance and Investment Fiduciaries* (Lawbook Co, Sydney, 2003) Especially chapter 3 addresses this matter – described as "Legal Limits on Institutional Investors Engaged in Corporate Governance".

[76] See Pamela Hanrahan, Ian Ramsay and Geof P. Stapledon, *Commercial Applications of Company Law* (8th edition ed, CCH Australia Ltd, Sydney, 2006) at para 9-270 and H A J Ford, R P Austin and Ian M. Ramsay, *Ford's Principles of Corporation Law* (LexisNexis Butterworths, Chatswood, NSW, 2005) at para 8.020. Note that while an appointed director must be a person, a shadow director can be a company as in *Standard Chartered Bank of Australia Ltd v Antico (1995)* 13 ACLC 1

[77] Robert Parrino, Richard W. Sias and Laura T. Starks, 'Voting with their Feet: Institutional Ownership Changes around Forced CEO Turnover' (2002) Vol 68 (Iss 2003) *Journal of Financial Economics* Pp 3ff

The fact that some market participants might be informed of a relevant matter while others are un-informed is a classic and simple information asymmetry. The underlying principle of market disclosure is to avoid such an occurrence – in the belief that an equally informed market will function best. While it is hard to see how any private consultation between any individual investor or sub-group of investors and the corporation in question can avoid such an outcome of information asymmetry, it is also important to retain a sense of proportion with the significance of that asymmetry compared to insider trading and conflict of interest issues. Almost any intelligent and energetic investor will have an information asymmetry with other less motivated investors – be they rationally apathetic or not. In untangling the complex of issues involved when institutional investors take an activist role – which includes some private consultation – a judgement on the significance of breaches of perfect market purity need to be made.

It is in conflict of interest on the part of the institutions that is of more concern. Where an institution that is an investor - owing fiduciary responsibility to a collection of contributors – but also has other commercial transactions with the investee entity, the risk of severe conflict can arise. The possibility of (say) the investment arm of a financial institution trimming its actions to suit the interests of (say) its merchant banking arm could represent a very severe conflict. This arose and was quite well documented – and indeed led to the matter being brought before the courts – in the Hewlett-Packard merger with Compaq. In that case, HP representatives are - apparently – shown to have identified that one institution (Deutsche Bank) would vote against the merger in their capacity as investor, and seeking – apparently successfully - to influence it to take the opposite view by leveraging the bank's wider banking relationship.[78]

Part E THE CONTROVERSIES OF THE PRESENT

Ronald Gilson and Reiner Kraakman's 1991 article "Reinventing the Outside Director: An Agenda for Institutional Investors" was a "calls to action" for institutional investors.[79] That article seeks to establish how institutional investors should behave if they are to be optimally effective as shareholders – with a focus on their role in the appointment of directors. Although much has happened in the 15 years since it was published, it still serves as clarion call to institutional investors to widen their activities from the review of firm performance. Its special emphasis is a call to influence change in the constitutions of entities in which they hold a position towards an optimal structure for the way the board is formed and operates.[80]

It could be said that shareholders are represented by the directors that they appoint and who they entrust to control and direct the management of the company. So described, the directors are the

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[78] This is reported in Stephen Davis, Jon Lukomnik and David Pitt-Watson, *The New Capitalists: How Citizen Investors are Reshaping the Corporate Agenda* (1st ed, Harvard Business School Press, Boston, Massechusetts, 2006). In turn, Davis et al attribute their source to Luh Luh Lan and Loizos Heracleous, 'Shareholder Votes for Sale' (2005) Vol 83, Iss 6 (June 2005) *Harvard Business Review* Pp 20. This is a very abbreviated statement of Lan's and Heracleous' study of the matter but a fuller version is available (and on hand) – and will be further explored in an upcoming edition of the journal "Corporate Governance"

[79] Ronald J. Gilson and Reiner Kraakman, 'Reinventing the Outside Director - An Agenda for Institutional Investors' (1991) Vol 43 (April 1991) *Stanford Law Review* Pp 863ff

[80] *"How then does a passive institutional investor improve the performance of the entire corporate sector? The only plausible answer is by improving the corporate governance system rather than by attempting to improve the management of individual companies"*
Gilson & Kraakme, ibid at P 867

critical mechanism whereby the shareholders communicate their preferences and demands to the management. Indeed the directors acting together – the board – is both the focus of legal responsibility for the entity and the focus of its corporate governance. However directors can only be taken to successfully achieve the control and direction of management if shareholders take the opportunities available to them to appoint – and dismiss – the directors, and to provide them with enough direction for them to be effective in respecting their wishes. Directors over the appointment of whom shareholders have no material influence, and towards whom shareholders are silent, cannot be expected to do more than minimally represent their wishes and interests.

At the same time, management may seek to protect its position. Management may wish to have a dominant influence on the appointment of directors and on the outcome of their deliberations. Of the ways that might happen two deserve specific mention. First, "Poison Pill" mechanisms generally involve regulations in the company constitution that are triggered by corporate control transactions and take effect to protect management from the take-over or its consequent risks. Second, the nomination procedures for new directors, the duration of their appointment, and the procedure whereby votes are cast and counted can exclude applicants for election that are not favoured by management, or otherwise lead to outcomes inimical to the preferences of some or all shareholders.

Mainly, these matters are not defined by Company law but are instead determined by the company constitution. They represent then areas that can be directly influenced by institutional and other shareholders. In Australia, there are "default" terms for a company constitution in the "replaceable rules". In other jurisdictions there are "model" constitutions that perform a similar role – a suggested constitution that inherits some degree of legitimacy from the source of the suggestion, but is not compulsory.

The first issue is the question of "staggered boards". When a company is under-performing, the shareholders may prefer to replace the board. In many such cases, the existing management could hold an opposite preference and wish only some or even none of the directors be replaced. However, a spill of every director – whatever "new broom" qualities it might bring – is difficult to force against directors whose appointment would other wise be continuing. In a "staggered board" only some directors retire each year.[81] When directors retire by rotation, it is easier to either infiltrate newer and more promising candidates onto the slate or persuade some from amongst them to avoid standing for re-election. The argument against staggered boards is that when only a part of the board is re-elected at the re-election opportunity, the "clean sweep" is effectively denied the shareholders. By comparison, if all directors are at one time liable for re-election, both the shareholders and the directors have more flexible options available to them. The "staggered board" structure is a corporate governance issue that can be addressed by constitutional change. Of course, constitutions tend to resist change!! In a free vote one might predict that many companies would find that shareholder support to remove an existing "staggered board" structure from its constitution was not strong. Hence some corporate governance polemicists seek to influence opinion in favour of the change away from staggered boards – a change the utility of which may or may not be useful, depending on future events.

[81] See generally Robert A. G. Monks and Nell Minow, *Corporate Governance* (3rd edition ed, Blackwell Publishing Limited, Malden, MA, USA, 2004) at page 231.

The second major issue involves "plurality" voting. In most jurisdictions, directors are elected singly[82]. In the US however a single vote in favour can be enough to elect a slate of candidates. The Council of Institutional Investors is actively campaigning for companies to change their constitution to allow for majority voting as it considers plurality voting to be a fundamental weakness of the US corporate governance system[83].

The third – but perhaps less actively debated – issue involves proportional voting. In summary, this allows an investor to use all his votes to just one candidate on the slate instead of needing to apply his votes evenly across all candidates.

The constitution of the board – its number and the qualifications and attributes of its members, as well as the separation of roles between (for example) CEO and Chairman – is another matter that shareholders can influence. While there are compulsory requirements in legislation, listing rules and best-practice in some jurisdictions, in jurisdictions where there are options available and especially where there might be contentious interpretations applied, shareholders may well seek to have some influence. A simple example of such a possibility applies with the Australian listed company AWB. In general, Australian listed companies are encouraged but not forced to have a majority of independent directors. In AWB's case, a number of directors who are raw material suppliers to the company (wheat grain growers) are elected by their fellow suppliers but ordained by the decision of the board to be independent. It is conceivable that holders of ordinary shares may not see such board members as independent. If so AMB's board structure fails the test for independent directors that apply in the relevant jurisdiction – guideline/principles rather than stsutory obligation though they be,

The decision of a board to form committees is another area that shareholders – including institutions – may well wish to influence. Generally shareholders may wish to see Nomination, Remuneration and Audit Committees formed and could well seek to pressure their formation if an individual company resists. The advisability of a "Shareholder Advisory Committee" arises to provide a standing conduit for the interchange of views between the board and the shareholders.

Other issue of similar nature include the right to have material in support of a shareholder motion distributed with the AGM notice papers and the right to call an extraordinary meeting of shareholders – a meeting other than the AGM. Like some issues above these areas can encourage and support the interventionist activities of institutional investors or impede them.

"Precatory" resolutions are resolutions that – while not binding - register a preferred course of action. They have two distinct but overlapping roles for institutional investors. They can allow motions to be put to a shareholders' meeting that might otherwise be an invalid intrusion into the rights that a board normally reserves to make management decisions without interference from the shareholders. But they also serve a valid purpose in putting on the (usually) public record the preferences and implied criticisms expressed by the shareholders. In general "PR" terms they put the directors in a position of needing to justify their actions. They can also register a public reprimand that press coverage can make hard to ignore. Advocates of "black letter law" might

[82] In Australia s 201E of Corporations Act only allows the election of multiple directors in a meeting if there is unanimous support for that process or by poll so long as members are NOT required to vote in a block. Even the block appointment of uncontested candidates can be invalid if *Oliver v North Nugetty Agency Co NL* [1912] VLR 416 is found applicable. Thus this issue of "plurality viting" does not apply in the Australian situation

[83] Council of Institutional Investors (CII), *Majority Voting Primer*, http://www.cii.org/policies/MajorityVotingPrimer.pdf (accessed on 28 December 2006),

ague that precatory resolutions are meaningless because they are (by definition) not enforced - relying on optional adoption they might say is relying on the unreliable.

However there are sufficient examples of boards responding to precatory resolutions that they should not be quickly dismissed. One interesting example is the decision by Pfizer to implement a directors' resignation policy that means in effect that directors who suffer an election rejection will voluntarily resign. It is especially interesting as a motion to similar effect was put and lost – but with considerable support. A second example is the recent changes to the Australian Corporations Act to require a non-binding vote on the proposed directors' remuneration report. This change forces an expression of support or dissatisfaction into the open. On the face of it, it can be seen as ineffectual but the longer term impact - the probability of a negative vote engendering restraint in subsequent years – is yet to be revealed and may well be significant.

In 1993 Joseph Grundfest drew on both his academic qualifications as Professor of Law at Stanford, and his experience as Commissioner of the SEC to write an article "Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates".[84] There he exhorts shareholders to use the protest vote to register dissatisfaction with directors' performance – even without proposing a more positive alternative.

To return to the issue of "enforcement and compliance". The issues above are mainly issues that institutional investors may well seek to influence. Although some may require some adjustment to either company law or influential guidelines issued by exchanges, the effect of those changes to allow facilitate or encourage institutional investors to express their preferences to boards with impact – but not necessarily compulsion. Of course ordinary shareholders could use the devices in the same way – but will probably not because of the implications that evolve from the "dispersed shareholder" phenomenon.

Part F THE CUSP OF CHANGE

Whatever opportunities exist for ordinary or institutional investors to register their views and lobby for change within the corporate organisation, any decision to encourage such expression – or indeed to mandate the manner of its expression - invokes discussion of the underlying purpose of both the corporate organisation itself, and the influences for change.

Back in 1982, Daniel Fischer put the problem of confusing corporate governance with non-business issues quite firmly.[85] He spoke against what he saw as a misguided attempt to blame corporate governance for social failures – and to pollute the simple efficiency of a market dominated and market regulated pursuit of profit by corporations. Arising from that error, he saw the argument for changes in corporate governance practices that might bring an improved social result as using the wrong solution to fix an irrelevant problem. In particular the idea of

[84] Joseph A. Grundfest, 'Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates' (1993) Vol 45, No 4 (April 1993) *Stanford Law Review* Pp 857ff

[85] Daniel R. Fischel, 'The Corporate Governance Movement' (1982) Vol 35 No 6 (November 1982) *Vanderbilt Law Review* Pp 1259ff

shareholder democracy was – as he saw it – a cloak to use to invest corporate governance changes with a false legitimacy.

The history of the involvement of institutional investors in social issues and their use of pressure to address non-commercial issues is quite well established. Indeed the use of pension funds by trade unions to improve their negotiation with employers lead the US Congress in 1947 to prevent the unions from operating in the pension area.[86] Equally the long development of a theory to support the widening of corporate responsibility to embrace "social responsibility" and the rights of "stakeholders" as well as shareholders, has in recent times solidified into "team production theory" and justifications for such an enlarged agenda.

Chancellor Strine's almost vitriolic attack on the presumptuous nature of institutional investors use of their corporate influence to forward a social or political agenda was reported earlier. (See Page 17 – Part C) But Roberta Romano had sounded her concerns much earlier in 1993. [87]

Notwithstanding the informed and persuasive opinions of Strine and Romano, there is an argument that while most normal investors can choose to obligate the corporation that they invest in to be "socially responsible", institutional investors have a special and more readily justified mandate to do so.[88]

An investor in a single equity has a clear financial focus – he wants to see that entity prosper financially. He may not be so greedy as to aspire to growth at all cost – ignoring both environmental and ethical implications – but he typically aspires to growth from economic or market improvement, market share expansion, and improved profitability and efficiency in operation. Because he is not diversified, he is disadvantaged if the fortunes of the individual equity in question suffer reverse – either because of misadventure affecting that equity alone or because it is impacted by poor economic or market conditions.

The diversified investor holds some position in a number of entities and while he hopes to see all prosper he also hopes that misadventures befalling any one (or few) will be counter balanced by good fortuning smiling on others. He accepts that economic conditions could cause a negative impact on most of his interests, but he hopes that there will be some less impacted than others.

Consider now another investor who holds a substantial position on a very large number of entities – indeed if not all listed entities in his market, at least the majority of the significant ones. Further, if he follows an indexed approach, the extent of his investments in each constituent entity is of a determined scale. In large part his interest now turns from individual firm performances and the fluctuations in fortunes between each, where the success of one is largely at the expense of another, to the overall market.

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[86] See Supra Note 7

[87] Roberta Romano, 'Public Pension Fund Activism in Corporate Governance Reconsidered ' (1993) Vol 93 No4 (May 1993) *Columbia Law Review* Pp795ff

[88] The thesis of this section owes reference to two major sources…
Stephen Davis, Jon Lukomnik and David Pitt-Watson, *The New Capitalists: How Citizen Investors are Reshaping the Corporate Agenda* (1st ed, Harvard Business School Press, Boston, Massachusetts, 2006)
And
James P. Hawley and Andrew T. Williams, 'Shifting Ground: Emerging Global Corporate Governance Standards and the Rise of Fiduciary Capitalism' (Paper presented at the Global Standards Conference, University of Oxford, 20-22 November 2003) - permission to cite this reference was obtained from the authors who advise that an amended version of the paper is due for publication in "Environmental Planning A" Vol 37 Issue 11, Pp 1995-2013

There is a further development when the investor undertakes two additional steps. First he might extend his investment activity from the market in which he started to take a significant position into a number of overseas markets. When such a development occurs the investor's focus on "market" really becomes an embrace of global commercial activity. Now the investor's concerns transcend any one market and form a more abstracted view of corporate activity. Secondly he may well make common cause with professional colleagues who reinforce this abstracted view. If he subscribes to and supports the recommendations of collectives such as ACSI and CII or if he buys advice services from ISS and Glass Lewis he commits (in a small way perhaps) to a collective energy to "improve" the practice of corporate governance overall – not just in one market but globally.

Such an investor is different from the "diversified investor" described above in that he is "ultra diversified".

The scenario above is unfolding with institutional investors, but with an added component. The more the institutional investors are themselves dominated by pension and superannuation funds the more they can adjust their thinking to the very long term. The more the collective mentality develops amongst the institutional investors that they are managing the long-term future of all salary earners in all markets, the more their definition of "fiduciary duty and obligation" extends beyond this season's dividend to a concern that could be called "fiduciary capitalism" - in which non-pecuniary externalities of individual firms become internalized.

One additional point involves the blurring of the role of the investor when his investment is infrastructural. In comparatively recent times – say over the last hundred years – citizens have looked to the state to provide certain facilities that all might use. The specifics varied from one jurisdiction to the next but public transport, telecommunications, power and energy utilities are typical examples. In more recent times those facilities have often been "privatised" – converted to private ownership with the consequent assumption that the facility will be operated profitability for the benefit of the new owners. In general the process to achieve that conversion has obligated the acquiree of the facility to perform to some defined standards so that the comfort of the population who rely upon it are not grossly disserved by the conversion.[89] In these circumstances the profit motive of the enterprise remains but it is understood to be exercised in the context of quality performance obligations as expressed by the wider-community. This is different to the obligation to provide good service to customers only in degree but the degree brings some subtle implications to the purpose of the corporation as its very existence – not just its partial profitability - is imperilled if its service quality performance is breached and its mandate withdrawn. [90]

Current circumstances conspire together then to move the focus of institutional investor activity from seeking improvement in their position by addressing recent firm profit performance(s) to

(a) targeting the practices of corporate governance world-wide and

[89] The "new regulatory state" is claimed to be Thatcher/Reagan consequence in an exposition of this issue that is interesting, widely applied and soundly referenced in Christine Parker, *The Open Corporation: Effective Self-Regulation and Democracy* (Cambridge University Press, Cambridge/New York/Port Melbourne etc, 2002)
[90] This conundrum is charmingly explored in Robert A. G. Monks and Nell Minow, *Watching the Watchers: Corporate Governance for the 21st Century* (Blackwell Publishers, Massechusetts/Oxford, 1996) under the fictitious title of Boothbay Harbour. In turn, Monks and Minow attribute the original story to William Z Ripley *Main Street and Wall Street* (Scholars Book Company, Kansas 1972)

(b) pressuring for reform in business practices to best support the widest definition of total long-term global-market sustainability

(c) while conceptualising the firms role – and the influences of the institutional investors – as benefactor of the wider stakeholder set.

These observations should not be taken to suggest that institutional investors have matured beyond profits and dividends. The point is that the horizon of the bigger institutions can gradually extend beyond to embrace wider concerns over time, or, might so extend if influence is not applied to avoid such a development – as will be further explored below.

Part G A RETROSPECTIVE ASSESSMENT.

Has institutional activism been effective so far?

In 2001, Jonathan Karpoff published his paper on the impact of shareholder activism[91] and, after a review of some 20 recent empirical studies, determined that while the individual studies came to mixed conclusions, by adjusting the definitions of activism and "success" concluded that actually the studies concur on some small effectiveness in changing governance but not in producing material improvement in firm result. However Karpoff's analysis is of pre-existing analyses that use data-sets that mainly end mid 1990's. It invites the possibility that he was seeing only the initial and hesitant start of a trend.

CalPERS is a famous activist company. The effectiveness of its activism was explored by both Claire Crutchley and colleagues in 1998[92] and by Prof Brad Barber in 2006[93]. Crutchley's analysis – based on firm performance from the "focus list" - suggested that there was a mid-term effect (up to 8 months) on firm performance after the firm's inclusion on a "focus list', but it was only really effective when it was part of very aggressive and visible effort by the institution to assert its views. Barber's later paper concludes that CalPERS has been effective in improving firm performance – and thereby gives us a more recent and quite specifically focussed conclusion to put beside Karpoff's work – but it is in the distinction between what he refers to as "shareholder activism" and "social activism" that Barber's work has most interest in the current context.

Barber describes a tension between CalPERS activities directed at conventional agency cost issues that (axiomatically) compromise shareholder returns, and its social activism concerns – concerns that may well lead to socially beneficial outcomes, but concerns for which CalPERS' mandate is unclear, and which will (in some cases at least) lead to reduced shareholder returns.

Taking both Karpoff's and Barber's work together this paper concludes that there are actually three separate areas that institutional investors can target…

a. Financial returns – either short or long run

[91] Jonathan M. Karpoff, 'The Impact of Shareholder Activism on Target Companies: A Survey of Empirical Findings' (2001) University of Washington [Available from

[92] Claire E. Crutchley, Carl D. Hudson and Marlin R.H. Jensen, 'Shareholder Wealth Effects of CalPERS' Activism ' (1998) Vol 7 (1) *Financial Services Review* Pp 1ff

[93] Brad M. Barber, 'Monitoring the Monitors: Evaluating CalPERS Activism' (2006) Winner 2006 Moskowitz Prize on socially responsible investing [Available from http://ssrn.com/abstract=890321] http://ssrn.com/abstract=890321

b. Corporate Governance – including executive compensation and poison pill anti-takeover defenses and allowing that there may be – or may not be – short or long term shareholder returns implications

c. Social activism and corporate social responsibility and environmentally sustainable concerns – that are not directly predicated on improving returns but could also have an impact on returns - but that those impacts could be negative as well as positive.

Accidental side-effects we will mainly ignore. However the possibility of well-meaning intervention by institutions can lead to unfortunate consequences. John Coffee blames institutional investors for introducing options into executive compensation packages as a device to coincide executive interests with corporate performance.[94]

After all the theoretical discussion and all the mis-givings about how institutions lack either or both incentive and opportunity, one big activist-oriented organisation has actually created a precedent for a generally effective activist role.

In October 2006 Frank Partnoy and Randall Thomas published a review of the impact of institutional investor activism in comparison with the impact of hedge funds.[95] While hedge funds can be considered as “institutional investors” they differ considerably from such as pension funds. As a general rule, hedge funds represent a more affluent investor and have more aggressive role in the market.[96] They have also attracted opprobrium for the aggression of their commercial endeavours.[97] Portnoy and Thomas conclude that while non-hedge funds might have had some influence in causing corporate governance changes, hedge fund activism is more concerned with

(a) initiating change of control transactions
(b) limiting voting activism to “change of control” or the threat thereof as opposed to corporate governance/constitutional change purposes
(c) aggressive use of litigation as opposed to consultation.

Chao Xi has recently contributed quite a revealing study of the role of institutional investors in China.[98] He challenges the conventional wisdom that minority shareholders are powerless and shows by example the role that institutional investors have had in influencing both regulation and corporate governance practice China. Interestingly he finds that recent changes – intended to protect minority shareholders - have actually diminished the potential for institutions to either hold large stakes (over 10%) or to engage in collectivist actions.

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[94] John C Coffee, Jnr, 'What Caused Enron? - A capsule social and economic history of the 1990's' (2004) Vol 89 (January 2004) *Cornell Law Review* P269ff at p 280. In turn, Coffee attributes the point to Amy L. Goodman, 'The Fuss Over Executive Compensation ' (1992) Vol 6 No 1 (Jan 1992) *Insights* Pp 2ff

[95] Frank Partnoy and Randall S. Thomas, 'Gap Filling, Hedge Funds, and Financial Innovation' (2006) Vanderbilt University Law School - Law and Economics [Available from SSRN Abstract 931254] http://ssrn.com/abstract=931254]

[96] Some notes on the institutional investor market will be available for distribution at the conference and are available on request. These notes include some comments on the characteristics of hedge funds that differentiate them from other institutional investors.

[97] Thomas W. Briggs, 'Corporate Governance and the New Hedge Fund Activism: an Empirical Analysis' (2006) [Available from

[98] Chao Xi, 'Insititutional Shareholder Activism in China' (2006) Vol17 (Issues 9&10) *International Company and Commercial Law Review* Pp251ff and 287ff

In a speech in 2002, Alan Greenspan put the potential, the necessity and the qualified indications of willingness for institutional investors to accept a wide responsibility quite firmly…

> *"After considerable soul-searching and many congressional hearings, the current CEO-dominant paradigm, with all its faults, will likely continue to be viewed as the most viable for of corporate governance for today's world. The only credible alternative is for the large – primarily institutional – shareholders to exert far more control over corporate affairs than they appear willing to exercise."*[99]

Part H CONCLUSION

This paper started by setting a challenge. The challenge was to achieve more appropriate corporate behaviour without adding yet more pages to the Corporations Act.

Institutional investors can do that. It is possible for them to both monitor performance and influence corporations to follow their will. Interestingly, in the UK, the Cadbury Report of 1992, the Greenbury Report of 1995 and the Hempel Report of 1998 all saw institutional investors as an especially important mechanism in bringing to fruition the corporate governance improvements that they espoused.[100]

The capacity and willingness to shape corporate policy and influence corporate governance structure is comparatively new. The methods available are still somewhat embryonic but indisputably nascent. We need to be aware however that if we encourage such a development, we will introduce a new set of agents and potentially a new set of problems as the current community of institutional investors are neither empowered nor qualified to take on an across the board corporate enforcement role.[101]

However, we need to separate enforcement from willing compliance – to recognise that willing compliance arises from a combination of two things: inherently accepted community standards and a belief that transgressions are not immune from negative consequence. It is in bringing to bear a combination of disclosure and expressions of moral reaction – either endorsement or outrage – that institutional investors are best placed to be effective. Indeed some could be said to see them as the empowerment of the citizenry.[102]

Lest anyone assume that the field is open for such a role, it must be recognised that management have something of a throttle hold on the lobbying influences available – at least in the US – and

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[99] Alan Greenspan, 'Corporate Governance',(Speech presented to, Stern School of Business, New York University, New York, New York, 26th March, 2002)

[100] This point should be credited to Christine Mallin, *Corporate Governance* (Oxford University Press, Oxford, 2004) – where supporting extracts are quoted on Page 65

[101] Generally - Brad M. Barber, 'Monitoring the Monitors: Evaluating CalPERS Activism' (2006) Winner 2006 Moskowitz Prize on socially responsible investing [Available from http://ssrn.com/abstract=890321] http://ssrn.com/abstract=890321

[102] Two mainly polemical texts would be
Stephen Davis, Jon Lukomnik and David Pitt-Watson, *The New Capitalists: How Citizen Investors are Reshaping the Corporate Agenda* (1st ed, Harvard Business School Press, Boston, Massechusetts, 2006)
and
Robert A. G. Monks, *The New Global Investors* (1st ed, Capstone (A Wiley Company) Oxford, 2001)

have been at pains to frustrate changes that undermine their control over the corporations they manage.

In his paper of May 2000, Luigi Zingales[103] puts forward a new conundrum about the firm. He recognises that firms are no longer so dependent on ownership of physical assets but more dependent on human capital, and he links the impact of that change with corporate finance theory, capital structure and corporate governance. The core governance problem becomes – not conventional agency costs – but the risk of centrifugal forces of disparate stakeholders initiating destructive disassociation of the human capital at the heart of this new corporation. In such a world, consensus becomes empowering and dissent destructive.

The potential for self-regulation and consensus attitudes to have a substantial bearing on the policies and behaviour of the corporation as explored by Christine Parker.[104] She is primarily concerned with reinforcing the processes whereby organisations can become self-regulating. Institutional investors are only one more mechanism is supporting that process.

Institutional investors have a unique opportunity. They can articulate to the organisation an informed view of the preferences of community – and they can do that with an enhanced authority based on the congruency of those views with substantial shareholding. But that is an idealistic situation. The most apparent example of an institution presuming to speak for the whole community is probably CALpers – and they are neither without error nor immune from criticism that they have overstepped their mandate.

The areas in which they can influence the corporations is best seen as simple continuum – starting with the core commerciality of "firm performance" and progressing from there to corporate governance issue and thence into such areas of "corporate social responsibility" as the partnership of institution and contributing members deem suitable.

The writer believes that the market will learn to ascribe an enlarged value on precatory resolutions – and all mechanisms together will improve the potential that exists for institutions to be a conduit of opinion and influence. The more improvement is achieved on that front, the less dependence on statutory regulation as the expression of the will of the majority. The solution to corporate misbehaviour is not black letter law – especially not when undertaken by single sovereign jurisdictions - as forces external to the corporate governance debate have made the capital market global for both corporations seeking capital, for trading opportunity and for investors seeking opportunity outside their home jurisdictions.

Nor should we expect that the behaviour of corporations be saintly. The acceptable standards of behaviour are a realistic balance of perfection and peccadillo as defined by the widest community standards. That the standards so widely defined are elusive is an obvious impediment to there adoption. One role for legislation can be to enforce disclosure and to facilitate scrutiny and discussion so that those elusive but widely held standards can become market dynamics based on reputational impact that assumes an "invisible hand" role.

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[103] Luigi Zingales, 'In Search of New Foundations' (2000) University of Chicago, Graduate School of Business, Centre for Research in Security Prices [Available from

[104] Christine Parker, *The Open Corporation: Effective Self-Regulation and Democracy* (Cambridge University Press, Cambridge/New York/Port Melbourne etc, 2002)

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