RESEARCH REPORT

INSTITUTIONAL INVESTORS'

VIEWS ON

CORPORATE GOVERNANCE

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I. Introduction

- The end of the 1980s takeovers boom heralded the rise of the institutional investor as a significant player in corporate governance. Institutional shareholders have moved to the front page through intervening to shake up the boards of underperforming companies; producing and promoting best-practice guidelines covering board structure and composition, executive remuneration, and a range of other matters; and actively participating in debates about corporate law reform.

II. The rise in institutional shareholdings

- The growth in institutional shareholdings in Australia in recent decades mirrors even greater growth elsewhere – particularly in the United Kingdom and the United States. As at 1994/95, institutions held 60 per cent of listed domestic equities in the UK, 52 per cent in the US and approximately 50 per cent in Australia. The combination of compulsory superannuation and the relative long-term outperformance of equities compared to bonds should see a continued increase in the level of institutional shareholdings in listed Australian companies.

- The rise in institutional shareholdings – with an accompanying increase in the concentration of shareholdings – has led many commentators optimistically to predict the end of the separation of ownership and control.

- Several US studies have tried to determine whether institutional investors have had any impact on corporate performance. The studies have produced mixed results – some indicate that institutional investor activism has a positive impact on corporate performance, some indicate that it has a negative impact, and some show no significant impact at all.

III. Background to the institutions interviewed

- Twelve major institutional investors were interviewed for this project. Each of the institutions was a member of AIMA, and is now a member of IFSA. As at 31 December 1997, collectively the 12 institutions had $150,946 million in assets under management. This represented 35 per cent of the total funds under management by AIMA's 57 members at that date.

IV. Views on key corporate governance issues

- Nine of the 12 institutions considered it important that a listed company have some independent directors on its board. Those nine institutions all expressed a preference for the board to have a majority of independent directors – which relects the AIMA/IFSA guideline.

- All 12 institutions said it was important that the chairperson and the CEO be different persons. The prime concern here was that of conflict of interest between the two roles.

- Only two institutions favoured institutional investors having nominee directors on boards of investee companies. It was generally believed by the other 10 that having nominee directors would present problems with potential conflicts of interest and the insider trading laws.

- Eight institutions said board nomination committees should be compulsory, though three qualified this by saying it did depend on the size of the company. Thus one institution said: "For bigger companies, a nomination committee makes sense; for smaller companies, the whole board could do it."

- Seven institutions supported a requirement that all boards have remuneration committees with a majority of independent non-executive directors. The other five institutions supported remuneration committees for larger companies, but not for small companies.

- Institutions were asked whether they monitored the performance of individual directors as well as the board as a whole. All the institutions said it was generally too difficult to monitor the performance of individual directors.

- All but one institution advocated performance-based remuneration schemes for executive directors and senior management, though opinions varied as to what hurdle rates should be set. Concern was more with the hurdle rates rather than the level of remuneration.

- Institutions were asked whether non-executive directors should also have performance-based remuneration schemes or should be paid a pre-determined fee. In line with the AIMA Blue Book guidelines, nine institutions objected to performance-based remuneration for non-executive directors.

V. Forms of involvement in corporate governance

A. Voting

- Nine institutions said their clients normally gave them the right to exercise voting rights attached to shares in their portfolios.

- Seven of the institutions said they voted on all matters. Another said its policy was to vote, though on rare occasions it would make a conscious decision to abstain. The other institutions said it was their policy to abstain unless the issue was something to which they strongly objected. The issue most likely to raise objection was executive remuneration schemes.

- Seven of the institutions said they had one or more clients who required that they be consulted prior to the institution exercising its vote.
- Ten institutions said they did not support making it a legal requirement that they report back to the client on how votes had been exercised.
- All but one institution had recently voted against a recommendation of the board or senior management of an investee company.
- Of the eleven institutions which had cast a "no" vote, nine had informed the company of the intention to do so beforehand.
- Ten institutions expressed their preference that contentious matters be resolved behind the scenes rather than put to the vote.
- Only three institutions supported the introduction of compulsory voting for institutional shareholders.
- Five institutions thought that voting should be done on a confidential basis. In line with US thinking, confidential voting was said to alleviate conflicts of interest.

B. Monitoring of investee companies

- Nine institutions reported they maintained frequent communications with their investee companies, generally with senior management. Typically, issues such as financial and economic conditions, strategic planning and management issues were addressed at these regular meetings.
- Two institutions commented that there was not enough meaningful contact between institutions and non-executive directors.

C. Specific instances of institutional intervention

- Each of the institutions had intervened in an issue of corporate governance in the preceding two years or so.
- Only two institutions said there had been any liaison with other institutions prior to taking action, though two others said that sometimes informal discussions and meetings did occur.
- When asked why they had chosen to intervene rather than just sell their holding in the company, two institutions responded that, given the substantial size of the shareholding (4-5 per cent and 7 per cent respectively), it was not possible to sell such a large holding all at once and obtain a reasonable price. Another two responded that, at the time, the shares were trading below the company's net tangible asset value, so selling was not a realistic option. The other institutions felt that

resolution of the corporate governance dispute in which they had intervened would lead to a better share price.

VI. Barriers to institutional investor activism

A. Legal barriers

- Eight institutions supported – in principle – the regulatory relief granted by ASIC which enables institutions to consult each other and enter an agreement to vote collectively at particular company meetings, without breaching the takeovers provisions. However, several institutions were unhappy about the actual form of the relief.

- All the institutions reported they were aware of the potential problems that the insider trading provisions could present, but said they had systems to prevent the provisions being a practical hindrance.

- None of the institutions reported that the "shadow director" provision in the Corporations Law had affected the conduct of their business or their relationship with investee companies.

- All institutions supported the repeal of section 1069(1)(k) of the Corporations Law – which restricts the voting power of unit trust managers. The section continues to apply to unit trusts until they register as managed investment schemes under the new Managed Investments Act regime.

- Eight of the 12 institutions supported extending the minimum notice period for general meetings. This occurred on 1 July 1998 (an extension from 14 to 28 days) under the Company Law Review Act amendments to the Corporations Law.

- Five institutions supported shortening the standard deadline for lodging proxies (48 hours before the meeting).

B. Economic barriers

- When dissatisfied with a company's performance or corporate governance, institutional shareholders have the option of doing the Wall Street walk (selling their shares) rather than intervening. However, all institutions reported that selling would generally be an option of last resort.

- All but one of the institutions reported they were conscious of the collective good/free rider problem, but only one reported that it acted as a disincentive to being actively involved in corporate governance.

- While admitting that effective monitoring comes at a high cost, most institutions considered it was a cost that could not be avoided.

- All but three of the institutions acknowledged the existence of potential conflicts of interest – arising from having additional relationships with companies whose shares they held (for instance, providing financial services to those companies).

C. Practical barriers

- None of the institutions said lack of information influenced a decision to intervene or not.

- Only two institutions conceded it is logistically difficult for institutions to meet at short notice, to discuss a problem concerning a company in which they hold shares.

- Only three institutions reported that a requirement to consult clients had inhibited them taking swift action.

Institutional Investors' Views on Corporate Governance*

I. Introduction

The end of the 1980s takeovers boom heralded the rise of the institutional investor as a significant player in corporate governance. Before then, their role in corporate governance had been confined largely to tendering – or not tendering – their shares to hostile takeover bidders. Since the late 1980s, however, institutional shareholders have moved to the front page through intervening to shake up the boards of underperforming companies; producing and promoting best-practice guidelines covering board structure and composition, executive remuneration, and a range of other matters; and actively participating in debates about corporate law reform. Indeed, the chairman of the Australian Securities and Investments Commission (ASIC) has expressed the view that shareholder action is "central to the proper functioning of our capital markets" (Callick 1994).

This Research Report highlights the role played by institutional investors in corporate governance in Australia. It details the findings of an interview study conducted in late 1997 and early 1998. Representatives of twelve institutional investors were interviewed about their role in corporate governance. Issues covered included their exercise of voting rights; their involvement in behind-the-scenes activism; and their views on a range of key corporate governance issues such as board structure and composition. Several of the issues covered in the interviews have been addressed in guidelines produced by bodies like the Australian Investment Managers' Association (AIMA) (which is now part of the Investment and Financial Services Association (IFSA)), the Bosch Committee, and Britain's Cadbury, Greenbury and Hampel Committees.

Section II of the Report provides a backdrop to the rest of the Report. It gives an overview of the growth – and implications of the growth – in institutional shareholdings. Section III then describes the institutions interviewed. The findings of the interviews are presented in Sections IV, V and VI. Section VII is the conclusion.

Section IV reports the institutions' views on several major corporate governance issues. A significant finding of the study is that individual institutions do not always agree with key guidelines – even those published by their own industry association. The point should not be overstated, however, because:

- it would be a rare industry association that could claim 100 per cent member support for all of its policies; and
- AIMA's key guidelines enjoyed the support of a majority of the institutions interviewed.

The institutions were also asked to describe the ways in which they have become involved in corporate governance at companies in which they hold shares ("investee companies"). The findings are reported in Section V. Section VI documents the

* Funding for this research was provided by the Australian Research Council.

institutions' views on a range of possible barriers – legal, economic and practical – to institutional investor activism. While acknowledging the existence of several barriers, most institutions took a pragmatic view. They considered that, if an issue is serious enough, shareholder activism is still a major option despite any regulatory and economic disincentives.

II. The rise in institutional shareholdings

The growth in institutional shareholdings in Australia in recent decades mirrors even greater growth elsewhere – particularly in the United Kingdom and the United States. As at 1994/95, institutions held 60 per cent of listed domestic equities in the UK, 52 per cent in the US and in the region of 50 per cent in Australia (Stapledon 1996b, 1998a; AIMA 1997). The lower figure in Australia reflects the prevalence of large founding family and intercorporate stakes in almost half of Australia's large and medium-sized listed companies (Stapledon 1996b).[1] However, the combination of compulsory superannuation[2] and the relative long-term outperformance of equities compared to bonds[3] should see a continued increase in the level of institutional shareholdings in listed Australian companies.

But why is the growth in institutional share ownership important? Who owned the bulk of listed equities before the institutions came along?

Aggregate share ownership statistics for listed Australian companies have only existed since the early 1990s. However, the UK's Central Statistical Office (1995) has figures on ownership of listed UK equities going back to the early 1960s. In 1963, individuals held 54 per cent of listed UK equities. This had fallen to just 20 per cent by 1994. In contrast, the holdings of institutions increased from 29 per cent in 1963 to 60 per cent in 1994.

A considerable majority of the shares held by individuals are held in relatively small parcels.[4] Therefore, in the early 1960s – and before – it is probably fair to say that the Berle and Means (1967) conception of a public company held true for many listed UK companies. Berle and Means, who studied the shareholdings of listed US companies in the late 1920s and early 1930s, found the typical company to have a mass of diffuse small shareholders (with directors and senior management owning only a very small portion of the shares). A small shareholder in a large company stands to gain only a small reward for any efforts at monitoring the board and senior management, because the benefits from monitoring are shared among all the (many) shareholders. But monitoring is costly, and therefore most small shareholders are "rationally apathetic". The chief concern of Berle and Means was

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1 Examples include the Murdoch interests' 31 per cent stake in News Corporation Ltd; AXA's 51 per cent stake in National Mutual Holdings Ltd; Malaysia Mining Corp's 47 per cent stake in Ashton Mining Ltd; Paul Ramsay's 44 per cent stake in Prime Television Ltd; and Rio Tinto's 67 per cent stake in Comalco Ltd. The institutional shareholding figure of approximately 50 per cent for listed Australian companies is a combination of the holdings of Australia-based institutions (33 per cent) and an estimate of the portion of the total overseas holdings (32 per cent) accounted for by overseas-based institutions.

2 The Federal Government's Retirement Income Modelling Task Force projects that the assets of Australian superannuation funds will grow in value from \$250 billion in 1996 to between \$1,494 billion and \$1,825 billion in 2020 – an increase in real terms of between 190 and 250 per cent: Financial System Inquiry (1997) p 128.

3 Taking 10 year rolling returns between 1900 and 1993, Australian shares returned on average 11.9 per cent per annum, compared with the average return on bonds of 5.0 per cent per annum and the average inflation rate of 4.6 per cent per annum: Mouatt (1994).

4 In the UK in 1994, nearly two-thirds of the shares held by individuals were in holdings of less than £100,000 value, and just over a fifth of them were in holdings of less than £5,000 value: Central Statistical Office (1995) p 8.

that "Where ownership is sufficiently sub-divided, the management can … become a self-perpetuating body even though its share in the ownership is negligible" (Berle and Means 1967, p 82). This gave rise to the famous expression "a separation of ownership and control": ownership resting with the myriad of small shareholders, and control residing in senior management.

It is not surprising, therefore, that the rise in institutional shareholdings – with an accompanying increase in the concentration of shareholdings – has led many commentators optimistically to predict the end of the separation of ownership and control.[5] In the US, this optimism has normally been qualified by a reference to a plethora of legal barriers to institutional investor activism that would need to be addressed if institutions are to become a true force as monitors of corporate managements.[6] Some commentators have also highlighted a range of economic barriers that arguably restrict the institutions' level of involvement in corporate governance even more than the legal barriers.[7] The practical significance of legal and economic barriers to activism in Australia was one of the key issues raised in the interviews. The findings are discussed at pages 29 to 39, below.

Has the rise in institutional shareholdings had a measurable impact on corporate performance so far? An Australian answer awaits the results of research being conducted by the Centre for Corporate Law and Securities Regulation, and the Department of Accounting and Finance, at the University of Melbourne.[8] As far as the US is concerned, Black (1998) reviewed the empirical studies which have tried to determine whether institutional investors have had any impact on the performance of listed US companies. The studies summarised by Black have, collectively, addressed these five issues:

- whether companies with a high level of institutional ownership, and therefore the possibility for accompanying monitoring, outperform companies with lower institutional ownership;
- whether institutional activism targeted at particular companies affects performance;
- whether there are abnormal share price returns around the date when a formal shareholder proposal is announced, or the date when a company announces acquiescence to an informal proposal;
- whether discrete corporate events (for example, subsequent CEO turnover or corporate restructuring) occur more frequently at companies that have been targeted by institutions for governance efforts; and
- whether a regulatory change that increases the potential effectiveness of shareholder activism results in abnormal share price returns for companies that had been targeted before the regulatory change.

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5 See, for example, Black (1990); Barnard (1991).

6 See, for example, Black (1990); Grundfest (1990); Roe (1994); Sametz (1995).

7 See, for example, Coffee (1991, 1994, 1997); Rock (1991); Stapledon (1996a, 1996b).

8 The research project, titled "The Impact of Institutional Investors on Capital Markets and Corporate Performance", is being funded by an Australian Research Council Collaborative Grant, in conjunction with

Black's review found that the studies produced mixed results – some indicate that institutional investor activism has a positive impact on corporate performance, some indicate that it has a negative impact, and some show no significant impact at all. Importantly, however, all of the studies focus on "visible" activism.[9] Behind-the-scenes (or "invisible") activism also occurs in the US, but by definition its impact is impossible to study in the ways summarised above. Yet it is entirely plausible that invisible activism is more effective than visible activism: UK institutions have emphasised that their most effective interventions have occurred away from the public spotlight.[10] The institutions interviewed in the present study were asked about their involvement in activism – visible and invisible – and the findings are reported at pages 25 to 28, below.

IFSA. The Chief Investigators for the project are Professor Kevin Davis, Professor Ian Ramsay and Dr Geof Stapledon.

[9] Recent studies (which also focus on visible activism) include Choi (1997); Gillan and Starks (1998); Rajgopal and Venkatachalam (1998); see also Ramsay and Blair (1993) pp 182-183.

[10] See the findings of the interview studies reported in Black and Coffee (1994) pp 2041-2055; Gaved (1995) pp 84-92; Holland (1996) pp 135-147; Stapledon (1996a) pp 117-131.

III. Background to the institutions interviewed

Twelve major institutional investors were interviewed for this project. Each of the institutions was a member of AIMA, and is now a member of IFSA.[11] As at 31 December 1997, collectively the 12 institutions had $150,946 million in assets under management. This represented 35 per cent of the total funds under management by AIMA's 57 members at that date.

The interviews were conducted in the latter half of 1997 and early 1998. In each case, the person responsible for oversight of corporate governance issues was sought for interview.[12] Depending on the size and internal structure of the particular institutional investor, this typically was the Director or Manager of Investments/Equities.

Five of the 12 institutions interviewed were fund management arms of insurance-based financial services groups. Another five were fund management arms of banking or investment banking groups. Of the remaining two, one was an independent fund management firm and the other was a large corporate superannuation fund. This superannuation fund used external fund managers. The other 11 institutions managed either a mixture of internal and external (client) funds, entirely external client funds, or (in one case) entirely internal funds. Of those 11, nine institutions described their management style as active and the other two described their management style as both active and passive, depending on the particular client mandate. Active managers are also known as "stock pickers" – they aim to achieve better returns than the market through active stock selection and trading. Passive managers are also known as "indexers" – they aim to match the performance of a particular basket of stocks, such as the All Ordinaries Index.

In determining the asset allocation within their portfolios, all institutions stressed the importance of their internal analysts' research. This was given more weighting than other sources of information such as broker research, financial data and annual reports. Internal research included analysts meeting with senior management of prospective investee companies.

Six institutions described their goal as "total return", being the combined impact of capital gain from investments, and income derived from those investments. Three institutions described their aim as "capital gain", and one described its aim as "income return". The other two institutions in each case said the primary aim depended on the particular client whose funds were being managed.

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[11] On 1 January 1998, AIMA merged with two other industry associations – the Investment Funds Association and the Life, Investment and Superannuation Association – to form IFSA.

[12] This reflects the approach taken in other interview studies. Mirador (1994) and Stapledon (1996a) conducted earlier Australian studies (in 1994). UK studies have been conducted by Black and Coffee (1994), Gaved (1995), Holland (1995, 1996, 1998) and Stapledon (1996a). O'Barr and Conley (1992) conducted interviews with large US pension funds.

Generally the institutions invested with a medium-to-long-term time horizon. Twelve months was considered medium term, anything longer was considered long term. One institution said it would like to be able to utilise ten-year time horizons.[13]

Asset allocation amongst the institutions was similar. At the time the interviews were conducted, each institution had approximately 40 per cent of total funds invested in Australian equities, with approximately 15 per cent of total funds invested in international equities. The balance was held in fixed interest (government bonds, etc), cash and property.

13 The alleged "short-termism" of institutions has been much debated in the UK and the US: see, for example, Marsh (1990); National Association of Pension Funds (1990); Stapledon (1996a) pp 212-237.

IV. Views on key corporate governance issues

The institutions were asked their views on a range of issues which have been at the heart of the corporate governance debate in Australia and overseas in recent years. Most of these key issues are addressed in best practice guidelines, like:

- the AIMA Blue Book guidelines (AIMA 1997);
- the guidelines produced by the Bosch Committee (1995); and
- the guidelines contained in the Combined Code in the London Stock Exchange Listing Rules.[14]

Of the three sets of guidelines, those in the London Combined Code have the most teeth. Every UK company listed on the London Stock Exchange must state in its annual report whether it complied with the Code provisions during the reporting period and, where it did not do so, why it did not do so.[15] In contrast, the ASX's corporate governance listing rule leaves it to each company to decide which corporate governance practices to discuss in its annual report, and what to say about them.[16] Extraneous guidelines therefore assume a greater importance in Australia. Given the growth in institutional shareholdings, the AIMA Blue Book guidelines could be expected to have particular significance in Australia – bearing in mind that all of the major institutions were members of AIMA (and are now members of its successor, IFSA). As mentioned earlier, however, the present interview study includes some interesting findings on the extent to which best practice guidelines actually reflect the views of major investors.

A. Composition of the board

(1) Independent directors

What the guidelines say …	
AIMA / IFSA	• a majority of board members should be independent non-executive directors
Bosch	• a majority of board members should be non-executive directors • at least one-third of board members should be independent non-executive directors
London Combined Code	• at least one-third of board members should be non-executive directors • a majority of the non-executive directors should be independent

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14 The Combined Code was derived by the Hampel Committee (1998) from (i) its own report; (ii) the report of the Cadbury Committee (1992); and (iii) the report of the Greenbury Committee (1995).

15 London Stock Exchange, Listing Rule 12.43A(b).

16 ASX, Listing Rule 4.10.3.

An independent non-executive director is a director who is independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgment.[17]

Nine of the 12 institutions considered it important that an investee company have some independent directors on its board. Those nine institutions all expressed a preference for the board to have a majority of independent directors – which reflects the AIMA guideline.

The stress placed did vary. Six institutions said it was "very important" for a board to include some independent directors. One of those said it had "great discomfort in investing in companies where there are no non-executive directors". Another said there was "not a lot of value in having executive directors on the board. What finance director is going to stand up to the CEO at the board table?" This is an interesting comment given Henry Bosch's recent prediction that "by 2010 the typical board will only have one executive on it – the CEO" (Bolt 1998).

Another institution stated that independence was important, but in itself not enough: "We like to see a united board with a good proportion of independent directors, but we also like to see directors with good qualifications." Another said: "The importance of having independent directors varies with the type of company and the type of industry in which the company operates. If an independent director can add value, skills and experience, then we want him on the board. But as a token, an independent who is not value creating, possibly value destroying, we'd have to analyse that."

Three institutions said having independent directors was not a major issue for them. Two of these said that, while their stated preference was to have independent directors, it was not a major decision-making factor.

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[17] This is the definition in the London Combined Code, para A.3.2. The AIMA Blue Book contains a more specific definition (AIMA 1997, para 3.2): "An independent director is a director who is not a member of management (a non-executive director) and who:

- is not a substantial shareholder of the company or an officer of or otherwise associated directly or indirectly with a substantial shareholder of the company;
- has not within the last three years been employed in an executive capacity by the company or another group member or been a director after ceasing to hold any such employment;
- is not a principal of a professional adviser to the company or another group member;
- is not a significant supplier or customer of the company or another group member or an officer of or otherwise associated directly or indirectly with a significant supplier or customer;
- has no significant contractual relationship with the company or another group member other than as a director of the company; and
- is free from any interest and any business or other relationship which could, or could reasonably be perceived to, materially interfere with the director's ability to act in the best interests of the company."

(2) Role of the chairperson

What the guidelines say …	
AIMA / IFSA	• chairperson should be an independent non-executive director • if not, the independent non-executives should appoint one of their number to be "lead director"
Bosch	• except in special circumstances, the roles of chairperson and CEO should be separate • where the roles are combined, appointment of an independent non-executive director as deputy chairperson should be considered
London Combined Code	• a decision to combine the posts of chairperson and CEO in one person should be publicly justified • in any case, there should be a "senior independent director" (a recognised senior member of the independent non-executive directors – separate from the chairperson)

Institutions were asked to explain what they perceived as the role of the chairperson of the board, and whether they considered it important that the positions of chairperson and chief executive officer (CEO) be occupied by different persons.

All 12 institutions said it was important that the chairperson and the CEO be different persons. The prime concern here was that of conflict of interest between the two roles. One institution said: "The board needs to look to long-term wealth creation; the CEO might only be on a three-year contract." Another said: "They have separate responsibilities. One is operational, the other is governmental."

Thus, the role of the chairperson was seen to provide some independence from senior management. Three institutions also mentioned the role of the chairperson as that of representing shareholders and providing shareholder access to the board if there were concerns with management.

(3) Nominee directors

Only two institutions favoured institutional investors having nominee directors on boards of investee companies. It was generally believed by the other 10 that having nominee directors would present problems with potential conflicts of interest and the insider trading laws.[18] Two institutions also said that their core business was making investment decisions – not running companies – and that having nominee directors could "reduce the efficiency of fund managers if they are tied up with various boards in terms of independence and it can compromise them".

Of the two institutions which supported nominee directors, one said it would not generally support them but, "during a time of crisis, an interim appointment of a nominee might be acceptable". The other said: "Institutions have been particularly critical of

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18 In regard to the insider trading laws, see pp 30-31, below.

corporate governance over the last 20 years. A nominee would ensure that that side of the company operated properly."

B. Board committees

(1) Nomination committee

What the guidelines say …	
AIMA / IFSA	• board should appoint a nomination committee (to make recommendations to the full board) • committee should be chaired by an independent non-executive director • a majority of the committee members should be independent non-executive directors
Bosch	• board should appoint a nomination committee (to make recommendations to the full board) • committee should be chaired by an independent non-executive director • a majority of the committee members should be independent non-executive directors • where the company or the board is small, an alternative may be appropriate[19]
London Combined Code	• unless the board is small, a nomination committee should be established (to make recommendations to the full board) • committee should be chaired by the board chairperson or a non-executive director • a majority of the committee members should be non-executive directors

Institutions were asked whether they thought nomination committees responsible for proposing new directors should be compulsory for publicly listed companies.

Eight said that they should be compulsory, though three qualified this by saying it did depend on the size of the company. Thus one institution said: "For bigger companies, a nomination committee makes sense; for smaller companies, the whole board could do it." Another added that not only should nomination committees be compulsory, they should be comprised predominantly of independent directors. Another institution said nomination committees should be comprised of "directors [who know] exactly why they've been appointed, what is expected from them, and with a review process after a year".

Four institutions said nomination committees should not be compulsory. One said that it was "awkward as they tend to bring similar people to the board". Another said: "One thing we have been involved in as a shareholder is actually helping boards find relevant persons. We are approached by companies to suggest individuals who may be appropriate as non-executive directors. This is a role institutions should become more involved in."

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[19] Here, the Committee says that "consideration should be given to alternative ways of demonstrating to shareholders that the process of director specification and selection is objective. This may involve the use of external professional advisers and additional disclosures": Bosch Committee (1995) p 23.

The fact that one-third of the interviewees were not enthusiastic about nomination committees might partly explain why the incidence of these committees has been considerably lower among large listed Australian companies than among large listed UK companies. Almost three-quarters of the Top 100 listed UK companies had a nomination committee as at 1994, compared to only 19 per cent of the Top 100 listed Australian companies a year later (Stapledon and Lawrence 1996).

(2) Remuneration committee

What the guidelines say …	
AIMA / IFSA	• board should appoint a remuneration committee (to advise the full board) • committee should be chaired by an independent non-executive director • a majority of the committee members should be independent non-executive directors
Bosch	• board should appoint a remuneration committee (to report to, and make proposals to, the full board) • no recommendation on committee chairperson • a majority of the committee members should be independent non-executive directors • where the company or the board is small, an alternative may be appropriate[20]
London Combined Code	• board should appoint a remuneration committee (to make recommendations to the full board on the company's framework of executive remuneration; and to determine on behalf of the full board the specific remuneration package for each executive director) • all committee members (including the committee chairperson) should be independent non-executive directors

Seven institutions supported a requirement that all boards have remuneration committees with a majority of independent non-executive directors. One institution said: "This would allow some objectivity and peer group comparison and allow the tapping of appropriate views within the industry." The other five institutions supported remuneration committees for larger companies, but not for small companies: "Once you get away from the top thirty or fifty companies, it becomes a burden. We prefer compliance with best practice rather than a certain structure to implement it." Similarly, another institution said: "It depends on the business. With a small company, you can't have [directors] sitting around in meetings all day. With BHP, it's a different organisational structure."

C. Assessing board performance

Institutions were asked whether they monitored the performance of individual directors as well as the board as a whole.

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[20] Here, the Committee says that "consideration should be given to alternative means of demonstrating to shareholders the objective basis of remuneration and related party transactions. This may involve the use of professional advice and additional disclosure": Bosch Committee (1995) p 31.

All the institutions said it was generally too difficult to monitor the performance of individual directors. One institution said this amounted to a "new science. We don't have a robust enough database on board members. The danger is of partial analysis. It gets back to the need to form an ongoing dialogue with the company." Three also mentioned the difficulty of assessing individual directors since the institutions were not actually attending board meetings themselves.

However, one institution said it did monitor individual directors, "particularly companies going through a change in the structure of the board or management. We will intervene to prevent the re-election of directors when they are associated with past events."

Another said it did "notice the performance of some directors if people get associated with companies that have not done well. You get them on a board if you can't find anyone else. It's a sign of trouble." Similarly, another institution said: "We expect the board to make changes when appropriate. There are certain individuals we would not want on a board: those associated with corporate failures or misbehaviour."

D. Director and executive remuneration

(1) Remuneration of the CEO and senior management

What the guidelines say …	
AIMA / IFSA	• board should disclose in annual report its policies on, and the quantum and components of, remuneration for all directors and each of the 5 highest-paid executives • in relation to executive share option schemes:[21] ◊ responsibility for their design and implementation should belong to the remuneration committee ◊ they should be designed around encouraging future performance, rather than to reward executives for past performance ◊ linking schemes to total return (ie share price growth plus dividends) is preferred
Bosch	• the remuneration arrangements for the CEO and other senior executives should be a function of the remuneration committee
London Combined Code	• board should disclose in annual report the company's policy on executive directors' remuneration, and comprehensive details of the remuneration of each director;[22] the board should consider each year whether the AGM should be invited to approve the remuneration policy • the performance-related elements of remuneration should form a significant proportion of the total remuneration package of executive directors • in relation to annual bonuses: ◊ performance conditions should be relevant, stretching and designed to enhance the business ◊ upper limits should always be considered • in relation to long-term incentive schemes (including share option schemes): ◊ payouts or grants should be subject to challenging performance criteria reflecting the company's objectives ◊ consideration should be given to criteria which reflect the company's performance relative to a group of comparator companies in some key variables such as total shareholder return

All but one institution advocated performance-based remuneration schemes for executive directors and senior management, though opinions varied as to what hurdle rates should be set. Concern was more with the hurdle rates rather than the level of remuneration.

One institution said: "Bad [remuneration] schemes are so obvious, they are symptomatic of poor management. They signal to their own people that certain people are getting a free lunch; they signal to potential investors that the company is not well managed. We like a remuneration policy linked to shareholder value. We have recently objected to 'in the

21 These guidelines are contained in AIMA (1994).
22 This has been a London Stock Exchange listing requirement since 1996.

money' option schemes where the hurdle rates have been a joke. We favour schemes based on total return."[23]

Another said: "We have concerns about excessive remuneration and the hurdle rates for option schemes. The financial benefit of those schemes should only occur if there is significant improvement in either operational or share price performance. Generally we prefer a share price barometer, relative to the market, over a medium-to-long term, five to ten years. The issue is having enough disclosure to make a judgment about what is appropriate, rather than quantum."

Similarly, another institution said: "We expect schemes to be generous. If not, they're not adequate. Performance-related pay is all the go at the moment and that's the way it should be. It has to be genuine performance-related pay; if the company is performing, they should be rewarded; if not, they shouldn't."

Another institution stressed that remuneration schemes should be tied to performance indicators other than share price: "Share price is a reflection of the overall strength of the market rather than the skill of the particular manager running the company. We prefer schemes tied to earnings or dividend stream."

The interviews were conducted before the Company Law Review Act was passed. That Act significantly strengthened the disclosure requirements for directors' and senior executives' remuneration – in line with the AIMA Blue Book guideline summarised in the above table.[24] Four institutions raised the issue of disclosure of remuneration schemes. One said: "Disclosure should be required of those who have a decision-making capacity which influences the future of the company. We support the US and UK standards for disclosure in the annual report." Another institution commented: "The annual report only gives the range of the terms of the remuneration; it does not give the guidelines that were used"; while another said: "It would be nice if you could actually identify who each of [the directors] was from the schedule that is in the annual accounts." These concerns are likely to have been addressed by the Company Law Review Act changes.

One institution thought that directors should not have performance-based remuneration: "We prefer directors to get a straight cash salary. We don't like any financial incentives for directors. We are happy for executive directors to be given shares in lieu of directors' fees and strongly encourage directors to be shareholders. But it should be either cash or shares. If directors are doing what they should be doing, they should be paid well."

(2) Remuneration of non-executive directors

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[23] Total return refers to share price growth plus dividends.

[24] See now Corporations Law, s 300A. AIMA (and subsequently IFSA) lobbied hard for this reform: see Parliamentary Joint Committee on Corporations and Securities (1996) paras 2.113-2.115; (1998) paras 1.36, 1.53-1.54. It was introduced as one of the last-minute changes to the Company Law Review Bill, without Government support, in order to have the legislation operational on 1 July 1998 (Main 1998). The Government subsequently referred the matter to the Parliamentary Joint Committee for examination (Main 1998).

What the guidelines say …	
AIMA / IFSA	• board should establish, and disclose in annual report, a policy to encourage non-executive directors to invest their own capital in the company or to acquire shares from allocation of a portion of their fees • non-executive directors should not participate in a share option scheme designed for executives
Bosch	• the remuneration of non-executive directors, including all benefits such as options, rights and pensions, should be fully disclosed to shareholders and approved by them • the level of remuneration should reasonably reflect the responsibilities and risks of being an effective director
London Combined Code	• the board or, where required by the company's constitution, the shareholders should determine the remuneration of non-executive directors

Institutions were asked whether non-executive directors should also have performance-based remuneration schemes or should be paid a pre-determined fee.

In line with the AIMA Blue Book guidelines, nine institutions objected to performance-based remuneration for non-executive directors. The principal basis of the objection was the potential conflict of interest and the compromise of their independence, and their role as monitors of management. Thus, one institution said: "The role of non-executive directors is to control risk and, if you give too many performance-based schemes, they might disregard the risk."

Another said: "The negative [aspect of performance-based remuneration] is the potential for short-termism. Also, directors should be sufficiently rewarded in fees and, if they are shareholders, they pick up their reward the same way as everyone else." Another said non-executive directors "should own shares in the company. We have no problems with fees being paid in the form of shares but, other than that, they should receive a fixed fee for a fixed job."

One institution said there should be a minimum performance standard such as the number of meetings attended, and that directors should be required to undergo sufficient training so that they understand the needs of the business operated by the company.

V. Forms of involvement in corporate governance

A. Voting

Perhaps the easiest way an institution can involve itself in the governance of a company in which it has invested its clients' funds is by actively voting on resolutions put to the general meeting.

(1) Delegation by clients of their voting rights

Where an institution manages some of its clients' assets in a pooled fund – that is, a unit trust or a pooled superannuation trust – the institution has power to exercise the voting rights attached to equity investments of the pooled fund (Stapledon 1998b). The clients are unitholders in the pooled fund and cannot individually give voting directions to the institution managing the fund.

The situation is completely different in the case of a "discrete client" – that is, a client whose assets are managed as a separate or discrete portfolio (rather than collectively with those of other clients in a pooled fund). The voting rights attached to equity investments of a discrete client belong to that client unless it has authorised the fund manager to exercise the voting rights on its behalf. Often a discrete client will be the trustee of a large superannuation fund. There has been some debate in the past as to whether superannuation trustees can properly give this voting authorisation (Stapledon 1998b), but all institutions interviewed assumed they were properly authorised.

Each institution was asked whether it used the *AIMA Standard Investment Management Agreement*. Under clause 12 of the AIMA standard agreement, the client (commonly a superannuation fund trustee) authorises the fund manager to exercise the voting rights attached to shares forming part of the investment portfolio. The fund manager may vote or decline to vote as it sees fit, subject to any direction from the client. Alternatively, if the institution did not use the AIMA standard agreement, did its own typical investment management agreement contain a clause similar to clause 12?

Ten institutions said they generally did use the AIMA standard agreement. Of the other two, one institution did not manage external clients' money and the other institution was a superannuation fund which employed external fund managers but always retained the voting rights.

Of the ten institutions which did use the AIMA standard agreement, nine said they did include clause 12 and were normally given the voting rights attached to shares in their portfolios, though some did say that a few discrete clients retained the voting rights in specific instances. Only two institutions unequivocally said they had no clients at all who retained any voting rights.

Where clients had retained the voting rights, these had related to specific issues and had been rarely exercised. There was a slight perception amongst those interviewed that public-sector clients were more likely to want to retain their voting rights rather than private-sector clients.

(2) Exercise of vote versus abstention

What the guidelines say …	
AIMA / IFSA	• investment managers should vote on all material issues at all Australian company meetings where they have the voting authority and responsibility to do so • investment managers should have a written policy on the exercising of proxy votes that is approved by their board, and formal internal procedures to ensure that that policy is applied consistently
Bosch	• shareholders should have made a sufficient analysis to vote in an informed manner on all issues raised at general meetings
London Combined Code	• institutional shareholders have a responsibility to make considered use of their votes

Seven of the institutions said they voted on all matters. Another said its policy was to vote, though on rare occasions it would make a conscious decision to abstain. The other institutions said it was their policy to abstain unless the issue was something to which they strongly objected. The issue most likely to raise objection was executive remuneration schemes; otherwise they would not vote on routine or mechanical matters. Thus, one institution's policy was to abstain unless its (external) investment manager insisted that voting was essential on the matter in question – in which case it would vote according to the investment manager's recommendation.

One institution which managed a mix of active and passive (or "index") funds noted that it never exercised the votes attached to shares in passive funds. This is not surprising, because the fees charged for passive management are considerably lower than those charged for active management – with the result that managers of predominantly passive funds will rationally take a minimalist approach to corporate governance (Coffee 1997; Rock 1991; Stapledon 1996b).

Another institution stated that companies sometimes called them to "get our support, and, if we agree, we're happy to give our proxy in favour of the chair".

Where there was a general policy to exercise the vote, there were still circumstances in which an institution might consciously choose to abstain. Generally this was on issues considered non-controversial and which did not impact or damage the valuation of the business. However, one institution did state that it might abstain to "keep rapport with the management". This raises the issue of conflict of interest – which is addressed later in the Report.[25] Another institution said: "There are degrees of aversion to particular proposals, and if you're not sure to vote for or against, it's best to abstain."

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25 See pp 36-37, below.

(3) Informing client on voting

What the guidelines say …	
AIMA / IFSA	• the investment manager should report back to the client when votes are cast (including abstentions) on investments owned by the client – as part of the regular reporting process to the client
Bosch	• no recommendations
London Combined Code	• institutional shareholders should, on request, make available to their clients information on the proportion of resolutions on which votes were cast and proxies lodged

Seven of the institutions said they had one or more clients who required that they be consulted prior to the institution exercising its vote. Three of those institutions said clients wanted to be informed on major issues only, such as remuneration schemes or the "sort of issues that make the papers". Another institution said that generally it did not consult clients, but "there may be some who wish to be consulted on certain issues. We use our discretion. If there were sensitive issues, we would consult."

Another institution said it was required to consult the client whenever there was a potential conflict of interest.[26] Conversely, one institution which never consulted the client prior to voting said it would not favour any requirement to consult: "We ask for the authority to vote or else you can do your own."

Recording of votes and reporting back to clients does occur, even when not specifically required by the client. Two institutions produced an annual report; three institutions produced quarterly reports; and another two produced monthly reports. Two others said they had the systems in place to produce regular reports, but had no clients who had asked for them. Two institutions said they did not produce reports unless required under the mandate with the client; one said it had clients who required six-monthly updates.

Ten institutions said they did not support making it a legal requirement that they report back to the client on how votes had been exercised. It was felt that clients were not particularly interested: "Clients don't really care, they care about performance and not much else." Another noted the "administrative burden and difficulty of custodians determining which parcel of stocks belong to whom in relation to voting".

Another institution said that, while it did not support making reporting of voting a legal requirement, "it is important if you're voting on someone's behalf to tell them what you've done. Clients, fund managers and trustees are still coming to grips with their roles." According to this institution, reporting is part of the service to the client, and it is not necessary to make it a legal requirement.

Two institutions did support a requirement for regular reporting: "The client should be fully informed of what actions their managers are taking on their behalf."

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26 For further discussion of conflicts of interest, see pp 36-37, below.

(4) Voting against management

What the guidelines say …	
AIMA / IFSA	• institutions should support boards by positive use of their voting power unless they have good reasons for doing otherwise
Bosch	• no recommendations
London Combined Code	• no recommendations

All but one institution had recently voted against a recommendation of the board or senior management of an investee company. One institution did draw the distinction: "We've certainly voted against directors. We'd normally vote with management, but that may mean voting against [a recommendation of] directors."[27]

One institution which kept up-to-date records noted that, out of 600 votes cast, only 13 had been "no" votes. Another institution said that voting against the management or board was "quite rare. We prefer to contact management, discuss issues and see if they will change their stance. We have voted against the buyback of shares at prices that would have affected the value of the company."

Ten institutions expressed their preference that contentious matters be resolved behind the scenes rather than put to the vote. A typical comment was: "A lot of work gets done behind the scenes which you would never see, so things quietly disappear off ballot papers simply because there may have been a simple mistake."

The one institution which could not recall voting against management or the board said: "Not a lot of contentious issues [get put to the vote]. It would be most strange to still be holding a share if you disagree with a board resolution."

[27] For an example of the (rare) situation where there is a major dispute between executive and non-executive directors, and the institutional shareholders side with the executives, see Gourlay (1992).

(5) Informing management or board prior to voting against

What the guidelines say …	
AIMA / IFSA	• if an institution intends to vote against a proposal, it may be appropriate for the institution to contact the company in time for the problem to be considered with a view to achieving a satisfactory solution • where a satisfactory outcome cannot be achieved on an important issue, it may be desirable for a spokesperson to attend the general meeting and explain why the proposal is being opposed
Bosch	• where appropriate, reasons for voting against a motion should be made known to the board beforehand
London Combined Code	• no recommendations

Of the eleven institutions which had cast a "no" vote, nine had informed the company of the intention to do so beforehand. One of those said it would only inform the company if it had a "meaningful holding – for example, we have over one per cent in a top twenty company". Another said it depended on the relationship the institution had with the company, "particularly in the case of smaller companies where we're a major player. In that case, we'd discuss it and they'd be aware of our intentions." Another said: "Typically, those companies contact us and we let them know what we think." One institution which did not normally inform the company said it "would not want to telegraph that [the intention to vote 'no'] to management or the company".

(6) Compulsory voting

Compulsory voting for institutional investors is a serious issue in the United States and the United Kingdom. Regulations made under the Employee Retirement Income Security Act (ERISA) require US private-sector pension plans to exercise the voting rights attached to their equity investments "on issues that may affect the value of the plan's investment" (US Department of Labor 1994). And the UK Government made it clear in early 1998 that legislation to mandate voting is a distinct possibility if the level of institutional investor voting does not increase (Martinson 1998).

Three institutions supported the introduction of compulsory voting. One of those did express the "need to do something on the costs of the systems involved; for example, Internet-based proxy lodgment[28] or proxy clearing houses" to reduce costs. One institution which did not support compulsory voting did acknowledge that a "higher participation rate in voting could be prima facie beneficial". Other comments were:

- "You run the risk of a vocal minority running the company, but people have the right to decide to vote or not";

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[28] Section 250BA of the Corporations Law (which was introduced by the Company Law Review Act 1998) allows – but does not compel – listed companies to specify an "electronic address" for the receipt of proxy forms.

- "Waste of time if [the issue being voted upon] is of no consequence. We prefer the current situation where we only vote if we feel the need; if it's an important vote";
- "Voting should be optional. [Compulsory voting] would entail an administrative cost which would impact on an industry which is aimed at wealth creation and supporting people's savings. Anything that detracts from that is a cost. It would not add value to the industry";
- "Our preferred system is for trustees and fund managers to understand the value of a vote and that it is a dereliction of duty if it is not exercised. If voting remains under 30 per cent, maybe [compulsory voting] needs to be introduced";
- "Some people invest purely to make money; others who feel a genuine sense of ownership and responsibility want to exercise their prerogative to vote. There is no gain from forcing people to vote, especially when the process is so cumbersome";
- "As a shareholder, you've paid your money. It's totally up to you [to determine] the level of participation you wish to exercise. As an institution, there are times when an abstention is far more powerful than a 'no' vote, far more useful, diplomatic and pragmatic";
- "I'm not sure what the benefits would be. It's very difficult when people are overseas or have no interest. Do you fine them if they don't vote?"

(7) Confidential voting

There has been a push by some US institutional investors, in recent years, for voting to be done on a confidential basis (Brancato 1997, p 107). Why?

> "Confidential voting prevents management from identifying opponents, pressuring them to change their votes, and sanctioning those who refuse to do so." (Rock 1991, p 490)

Five institutions thought that voting should be done on a confidential basis, one adding that all voting should be by proxy only. In line with the US thinking, confidential voting was said to alleviate conflicts of interest: "In certain circumstances there is a conflict of interest; the most obvious one is where the fund manager runs the super fund of a company and wants to vote against the management." The other seven institutions said they were not afraid to have the company know how they had voted. These institutions felt that an open vote had a greater impact in expressing dissatisfaction with the management of the company:

- "We would rather stand up and be counted";
- "If we were worried about confidentiality, we would attend the meeting and vote by proxy. We've never been afraid to exercise our vote and tell management what we don't like";
- "At the end of the day, if you are voting 'no', you are voting 'no' with the full power as fund manager, and the directors need to see that."

B. Monitoring of investee companies

A system for identifying potential problems within investee companies facilitates the role of an institution in corporate governance. The institutions were asked what monitoring systems they had in place and what sort of regular contact they maintained with investee companies.

(1) Systems for identifying issues

The institutions were asked whether they maintained formal systems for specifically identifying corporate governance problems or whether they were alerted to problems through the normal course of their investment monitoring operations.

Three institutions said they had formal systems. One institution said it held daily meetings in which information was shared amongst all its analysts.

Another – one of the larger institutions – delineated the manner in which an issue would escalate. First, the analyst responsible for monitoring the company would refer the matter to the head of equities. If required, the matter was then referred to the chief investment officer, then the CEO of the funds management division, then the CEO of the parent company, and finally to the chairperson.

In all three institutions, the person responsible for alerting the institution to potential problems was the analyst responsible for monitoring the investee company. Typically, the custodian (as the registered owner of the shares) passed on every company resolution to the analyst who would then make a recommendation on how to vote, giving reasons. Where a controversial matter arose, it was within the analyst's discretion, using internal guidelines and in two instances the AIMA Blue Book guidelines, as to whether a matter should be referred to a higher level in the institution.

One institution said it used Institutional Shareholder Services (ISS). (ISS is a Sydney-based proxy advisory organisation which monitors the AGM agendas of large and medium-sized listed companies.) With respect to smaller companies which ISS does not monitor, the institution's own research team was responsible for monitoring the company and making recommendations on voting.

(2) Communication with investee companies

What the guidelines say …	
AIMA / IFSA	• investment managers should encourage direct contact with companies including constructive communication with both senior management and board members about performance, corporate governance and other matters affecting shareholders' interests
Bosch	• institutional shareholders should take an active interest in the governance of companies • shareholders should not involve themselves in companies' day-to-day operations
London Combined Code	• institutional shareholders should be ready, where practicable, to enter into a dialogue with companies based on the mutual understanding of objectives

Nine institutions reported they maintained frequent communications with their investee companies, generally with senior management. Typically, issues such as financial and economic conditions, strategic planning and management issues were addressed at these regular meetings. In five of those instances, it was the responsibility of the analyst to maintain that contact; in three instances it was the responsibility of the portfolio or fund manager; in the remaining instance a "whole team" approach was adopted.

One institution commented that there was "not enough meaningful contact between senior members of investment organisations and non-executive directors. We need more meetings to discuss governance-type issues." Another said: "Our dialogue is quite strong with senior management, but pretty weak with directors. That area needs to be addressed by fund managers generally. Sitting with the independent directors of BHP is something that needs to be brought into the process, but it's difficult because they aren't always around."

Some institutions commented specifically on the frequency of meetings with investee companies. Two institutions reported that they met with investee companies at least twice a year. Another smaller institution said they visited companies approximately once every two years. Meetings between institutions and investee companies also occur at broker-organised lunches and Securities Institute of Australia (SIA) seminars. One institution noted that companies in which it did not hold shares, but which it monitored, would initiate contact with it.

Three institutions said they did not maintain regular contact with their investee companies. However, one of these was the superannuation fund which used external fund managers. It said it held regular meetings with its external fund managers to be kept informed of matters. Another said it held meetings only as issues arose; these might be with the managing director, finance director or chairperson of the investee company – depending on the specific issue. The third said it preferred to judge companies "on how the figures stack up".

C. Specific instances of institutional intervention

Each of the institutions had intervened in an issue of corporate governance in the preceding two years or so. However one institution did not consider action on its part as "intervention": "We have a close working relationship with those companies we invest in. We focus on the quality of the management, succession planning, strategic direction, audit trail, etc. We would not classify that as intervention but as healthy dialogue."

Holdings in investee companies in which there had been intervention ranged from 1-2 per cent in Top 100 companies up to a maximum of 18 per cent in a non-Top 100 company. Institutions were asked in what instances they had intervened and the specific matter to which they had objected. Also, they were asked why they had chosen to intervene instead of taking the "Wall Street walk" – that is, selling their holding in the company.

(1) Recent interventions

The most often cited (by five) matter in which the institutions had intervened was the Coles Myer controversy,[29] though each of the institutions had its own agenda even within that one dispute and so had differing areas of concern. Objections mentioned included potential conflicts of interest on the Coles Myer board, concern about the Yannon transaction, concern about a proposed dividend re-investment scheme, and the Coles Myer buyback of shares from K-Mart at what was considered an inflated price involving a destruction of shareholder wealth.

Three institutions cited ANI as an example of recent intervention.[30] In that instance, objection was voiced to a proposal to restructure the board. One institution held discussions with directors to determine which directors it should support: "We voted for the directors whom we thought appropriate, so some directors missed out as a result of our vote, and everyone else's. We had some impact on the decision." Another institution which also intervened at ANI did so because "the previous board had done deals with major shareholders which cost subsequent shareholders considerable amounts of money. The board split on who was responsible; the board changed and management changed."

Another institution had opposed a proposal that Crown Ltd buy the management rights of Melbourne's Crown Casino from Hudson Conway Ltd. Another intervention had concerned the hurdle rates for an executive share option scheme; the institution discussed this with the company and other institutions. The scheme was eventually redrafted and approved. Another institution had expressed its concern at the level of benefits being given to non-executive directors of one company, and the lack of clarity of benefits accruing to all employees and directors of another company.

One institution which had substantial shareholdings in two smaller companies (15 per cent and 18 per cent respectively) had intervened in one instance when some directors had

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29 See Deans (1995); Hurst (1995); Hurst and Pheasant (1995).

30 See Bartholomeusz (1996); Maley (1996); Ries (1996).

proposed to remove other directors and to adopt a policy for taking the company forward with which the institution did not fully agree. In respect of the other company, the institution wanted to reconstitute the board because the existing board had "failed dismally in terms of financial status and profitability".

(2) Liaison with other institutions

Only two institutions said there had been any liaison with other institutions prior to taking action, though two others said that sometimes informal discussions and meetings did occur. Another institution said that it was "against our interest to communicate to competitors our interest in a company and what we would like to happen. We like to keep that secret." One institution said it had been approached by other institutions on six occasions in the last two to three years, though no specific instances were recalled. The smaller institutions said they would be surprised if they were approached by the big institutions as they felt the size of their shareholdings to be too insignificant.

(3) Contact with companies

Where there had been institutional intervention, all institutions, with the exception of the superannuation fund which used external fund managers, had been in contact with the company at either the board or senior management level to discuss the issue of concern. Four institutions said they had held discussions with the CEO or managing director; in two of those instances the chairperson had also been contacted.

In two other instances, the finance director and corporate relations manager had been contacted. The other institutions did not specify at what level contact had occurred beyond the broad categorisation of board or senior management.

In six instances, institutions reported they had approached individual directors in the course of their intervention. One added that, "generally with contentious issues, we prefer separate meetings with executive directors and non-executive directors". Another institution which had approached individual directors said that, in this instance, "there was open warfare on the board, so it was appropriate to speak to the directors individually".

Within the institutions, it was the analyst responsible for monitoring the company who had responsibility for conducting the discussions although, if the issue escalated, the matter would then be referred to the investment director and, if the matter escalated further, it would then be referred to the managing director or CEO of the institution.

(4) Why intervene?

When asked why they had chosen to intervene rather than just sell their holding in the company, two institutions responded that, given the substantial size of the shareholding (4-5 per cent and 7 per cent respectively), it was not possible to sell such a large holding all at once and obtain a reasonable price. Another two responded that, at the time, the shares were trading below the company's net tangible asset value, so selling was not a realistic option.

The other institutions felt that resolution of the corporate governance dispute in which they had intervened would lead to a better share price. Several noted the current price of Coles Myer shares, it being much higher than the price at the time of the dispute in late 1995 and early 1996. Thus, one institution said that it would "not necessarily sell stock with poor governance practices if we believe that better returns will result from intervention". Similarly, another institution said it is possible to "be more effective and valuable in the whole corporate governance process if you talk to people rather than just sell".

One institution even considered that a company experiencing difficulties with shareholders in respect of corporate governance issues could represent a good opportunity to buy into that company: "If you employ a value style [of asset management], you buy into companies because they represent good value. You hope that value will be realised and you buy into them cheaply because there's a problem with the company, so it doesn't make sense to sell because of a problem."

For some institutions, selling of shares was considered an option of last resort. Thus, one institution said: "You would sell because you reckoned the thing was so serious that the [share] price wouldn't double perhaps, not because you don't approve of one particular thing." Similarly, another institution said: "If you go through the [dispute resolution] process and elevate [the dispute] to a higher level and still don't get any comfort, and the proposal were to significantly reduce the value of the shares or company value, then we'd sell."

Interestingly, one institution said: "A passive fund manager has a greater need to drive corporate value issues because he doesn't have sell as an option." However, of the various passive fund managers, it is only one managing wholly *internal* funds[31] that would rationally spend time and resources intervening on a corporate governance issue. A fund manager managing external clients' assets with a passive mandate – and the accompanying low fee – has no real incentive to do anything in the corporate governance field. Why? Because passive managers have a mandate merely to match the performance of the index; they are not expected to outperform the index. And of course they (and their competitors) can meet that expectation very cheaply by being "passive" in every respect – including the extent to which they become involved in corporate governance. The reference to their competitors is important because it highlights the fact that, if one or two institutions spend resources intervening and (hopefully) increasing the value of a company's shares, their competitors who also hold shares in that company can free-ride on their efforts.[32]

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[31] For example, an in-house manager of a large superannuation fund. The vast majority of Australian superannuation funds use external fund managers, but in other countries (like the UK) it is not uncommon for several of the largest funds to employ full-time in-house fund managers. However, in recent years there has been a trend towards replacing internal fund managers with external managers: see Cohen (1995).

[32] This point is developed at pp 35-36, below.

VI. Barriers to institutional investor activism

Institutions were asked their views on various factors which have been identified as barriers to institutional investor activism in areas of corporate governance.[33] They were asked whether they had found these barriers to be a practical hindrance, and what suggestions for reform they had. These barriers were broadly identified as legal, economic and practical.

A. Legal barriers

(1) Triggering the takeovers provisions

Australia has a statutory system for regulating takeovers and, as Hill (1994, p 606) points out, the provisions "are more than capable of catching conduct not strictly associated with a takeover bid at all". Part 6.7 of the Corporations Law contains provisions which require anyone who has a "substantial shareholding" (5 per cent or more) in a listed company to notify the company of the substantial shareholding and afterwards of certain changes to the holding. Section 615 of the Corporations Law prohibits a person from acquiring shares in a company if, after the acquisition, any person would be "entitled" to more than 20 per cent of the voting shares in the company. Arguably, the concept of "entitlement" to voting shares is so broad that Part 6.7 and section 615 of the Corporations Law could be breached when several institutional investors act collectively in relation to a company in which each has a shareholding.[34]

In November 1996 the Australian Securities Commission (ASC) (as it was called at the time) issued for public comment an Issues Paper in which it proposed to grant conditional relief to enable institutions to consult each other and enter an agreement to vote collectively at particular company meetings (ASC 1996). In May 1998 the ASC published a Class Order (ASC 1998b) which grants this conditional relief.[35] The interviews took place before the publication of the Class Order, but after the release of the Issues Paper. Therefore, the institutions were asked their views on the proposal contained in the Issues Paper.

Eight institutions said they supported the reform proposed in the ASC Issues Paper. In some cases this support was not unqualified. One institution said: "We support the ASC policy in principle, provided the ASC's discretion is used appropriately to allow action which was objectively based, not personally motivated. Institutions should ask the hard questions before any problems arise because their role is one of protection of stakeholder interest." Another said it supported the policy to grant relief, "but not as worded in the Issues Paper. It is very cumbersome. You are required to declare exactly what your conversation was about. It's ridiculous that shareholders can't talk to one another."

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33 These factors are detailed in Stapledon (1996b).

34 For further discussion of this issue, see Stapledon (1996b) pp 159-170.

35 See also the Policy Statement (ASC 1998a) which explains the policy behind the Class Order.

Similarly, another institution said: "There is certainly a lack of clarity about what institutions can do before they breach the takeover provisions. The ASC Issues Paper missed the issues. It said they would grant relief but you had to nominate whom you were seeing and ask for a special arrangement, whereas all we want is the ability to speak to each other. Also, there seemed to be a special offer to institutions that wasn't there for other shareholders. If the ASC and the Government want institutions to play a semi-regulatory role, we must be allowed to talk to each other without entering contracts." Another said: "It depends what particular aspects the institutions are interested in. On the corporate governance side, to act in concert seems quite reasonable. If it's to get around the 20 per cent rule [that is, the takeover threshold], then I would not favour that."

Objections to the grant of relief to allow institutions to act collectively were based primarily on the potential for abuse: "We have to be careful; it can be substantially abused." Two institutions pointed out that consultation between institutions was rare in any case because of the competitive nature of the industry: "The biggest barrier to institutions approaching each other is mistrust as competitors in an exceptionally competitive industry." The smaller institutions said they were not impacted by the law as their holdings were generally too small: "We are too small for it to have ever been an issue for us. We have no problem with people of a similar view voting the same way and discussing it beforehand. It's more an issue for AMP or National Mutual."

(2) Insider trading provisions

Institutions were asked whether they had found that the insider trading provisions[36] acted as a disincentive to their effective monitoring of investee companies. That is, did a fear of acquiring inside information – and being prohibited from trading the shares until the information was available to the market – restrict the level of monitoring carried out?

One institution stressed, as a preliminary point, that the continuous disclosure requirements now made it "incumbent on a company to disclose the information or do something about it".

All the institutions reported they were aware of the potential problems that the insider trading provisions could present, but said they had systems to prevent the provisions being a practical hindrance. Thus, one institution said it kept portfolio management completely separate from corporate governance: "Most corporate governance is done without reference to the portfolio manager."

The institutions also said that, when they met with directors or managers of a company, it was assumed those directors and managers understood the law and would not tell the institutions something they should not. One institution said it was the company's obligation to ensure it revealed only reasonable, public information, adding: "We would not expect to be told anything that wasn't." Similarly, another said: "Companies should know where the

[36] Corporations Law, Part 7.11, Div 2A.

boundaries are." One institution reported that there had been occasions when a company was about to reveal insider information and the institution had told the company to cease: "We value our ability to act independently more highly than whatever they are likely to say."

(3) Possibility of becoming a "shadow director"

Section 60(1)(b) of the Corporations Law defines the term "director" as including "person in accordance with whose directions or instructions the directors of the board are accustomed to act". This is commonly called the "shadow director" provision. In certain circumstances, institutional investors who become active in the affairs of the companies in which they invest could be shadow directors and hence subject to the directors' duties and insolvent trading provisions of the Corporations Law.

Institutions were asked if this impacted on how they monitored and intervened in the corporate governance of investee companies. None of the institutions reported that the definition of a director found in section 60 had affected the conduct of their business or their relationship with investee companies. One institution said: "If you hold two to three per cent of a company, the company will listen, but it's not persuasive." Another said: "We don't have a problem with [section 60] as we have a cultural antipathy to managing companies. Passive indexed investors are more tempted to take a management line."

(4) Former section 1069(1)(k)

Before 1 July 1998, when the Managed Investments Act overhauled the prescribed interest provisions in the Corporations Law, section 1069(1)(k) of the Corporations Law restricted the voting power of unit trust managers. It required that a unit trust deed contain covenants binding the trustee and manager not to vote the trust's shareholdings on any election of directors without the prior consent of the majority of unitholders. The ASC (1993) had granted limited relief to reduce the restrictiveness of the rule. Institutions were asked what difficulties the provision presented, and whether they supported repealing it. This is still a practical issue because there is a two-year transitional period for unit trusts to register under the Managed Investments Act regime. Until they come under the new regime, unit trusts will remain subject to the old law.

All institutions supported the repeal of section 1069(1)(k). The practical requirement of calling a meeting of unitholders was seen to be logistically difficult. The institutions said that unitholders were not even generally aware in which companies their funds were invested and were not usually interested; and that the investment manager, having been delegated the authority to vote in most instances by non-unit trust clients, should also have the authority to vote in respect of equities held through unit trusts.

One institution said: "It's logistically too difficult to put issues to unitholders. [Section 1069(1)(k)] is designed to make sure those shareholdings are never voted." Another said: "It's a complicated process of informing custodians about what they can do on which portfolios. [Section 1069(1)(k)] is there because of a fear of institutions acting on their own behalf,[37] but we are actually aware of our fiduciary obligation."

Another institution said: "The manager is delegated authority to manage the business; voting is part of that management of assets. It's a nuisance to have to circulate to unitholders who probably don't care anyway. As a default, the manager should have the right to vote on any issue." Another said: "If we want to vote, we want to vote all our shareholdings. If we can't vote our unit trust holdings without calling a meeting, then that's a restriction we prefer not to have. The unitholders don't even know they have investments in a company." Another commented: "[Section 1069(1)(k)] creates problems. Because we're actually dealing through custodians, we have to rely on them to ensure we don't breach [section 1069(1)(k)] by voting the whole lot. Also, it seems inequitable as we are voting our discrete clients across the board without any problems."

(5) Minimum notice period for general meetings

What the guidelines say …	
AIMA / IFSA	• the annual report, notice of meeting and other documents for all shareholder meetings should be sent to shareholders at least 28 days before the meeting
Bosch	• no recommendations
London Combined Code	• no recommendations

At the time of conducting the interviews for this study, the Corporations Law set the minimum notice period for general meetings at 14 days. As a result of amendments made by the Company Law Review Act, which became operational on 1 July 1998, the minimum notice period is now 28 days for listed companies, and 21 days for other companies. AIMA (and subsequently IFSA) lobbied vigorously for the change to a 28-day minimum notice period.[38] In the interviews, institutions were asked whether 14 days was sufficient time for them to respond to the calling of a meeting and resolve how they were going to vote, or whether the minimum notice period should be extended.

Eight of the 12 institutions interviewed supported extending the minimum notice period. This is another illustration of an AIMA/IFSA view that has majority – but by no means universal – support of member institutions.

Of the eight institutions which supported extending the minimum notice period, four supported an extension to 21 days, three advocated 28 days, and one called for 30 days. One institution noted that, though the minimum notice period was 14 days, the effective period

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[37] This is an accurate assessment: When the provision was first introduced into Australian company legislation, the Minister for Justice said that "the restrictions imposed by the Bill arise out of the necessity to impose some curb on the enormous power capable of being exercised, not by the interest holders themselves but by the managers of the [unit trust] who actually may have little financial interest in a particular trust": Harding (1994).

[38] See Parliamentary Joint Committee on Corporations and Securities (1996) paras 2.44-2.50; (1998) paras 1.45-1.47.

could be as short as seven days given the vagaries of the postal system and the time it took for the notice to get from the company to the custodian, and then to the institution's investment manager or analyst responsible for making the proxy voting decision.

Another institution described the difficulties with the process as follows: "We're dealing with custodians who themselves need five to seven days. The notices go to the custodians, then they send them out to us and then we have to give [the custodians] five days. That doesn't give us a lot of time to sit down and cogitate about the issue." Another institution said: "It's totally out of touch with the administrative realities of proxy voting. It's not enough time to consult clients if required. We advocate 28 days, particularly to enfranchise overseas investors". Another commented: "28 days would be a lot better for us. You've got various parties internally who need to review things, so the logistics of sending the proxy assessment around can be pretty cumbersome."

Of the four institutions that said the 14 days notice period was sufficient, one admitted that the deadline could be "a little tight if the issue is controversial and it's not an easy decision". Another institution which did not typically consult external clients found 14 days to be sufficient, but said that, with "the odd client who likes to be consulted, it gets a bit tight sometimes". Therefore, only two institutions said they had never encountered problems with the 14 day notice period.

(6) Proxy lodgment period

Section 250B of the Corporations Law requires proxies to be lodged at least 48 hours prior to the general meeting.[39] Institutions were asked whether they had experienced difficulty meeting this deadline.

Seven institutions said they were satisfied with the current requirement. One of those said that "48 hours is only not sufficient if the back office is slack". Another institution saw it from the investee company's perspective: "48 hours was always drafted in consideration of post. But if you look at Telstra, it'd take 48 hours to process all the proxies if all the little shareholders vote." Another institution supported shortening the time down to 24 hours, but qualified this by saying "it depends on the efficiency of the other side".

Of the five institutions which wanted the proxy lodgment period shortened, three advocated an electronic system which would allow lodgment closer to the time of the meeting. One institution said: "We strongly believe in electronic lodgment and that all voting at annual general meetings be by proxy. It's a real pain to lodge votes." Another said: "These days I don't see why 48 hours is necessary. I would have thought one hour would be sufficient. 48 hours is a relic of the non-electronic age."

B. Economic barriers

(1) The option of doing the Wall Street walk

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[39] The company's constitution or the notice of meeting may reduce the period: section 250B(5). However, it is common for the constitution to set the period as 48 hours.

Some commentators have argued that there is a fundamental difference between the type of shareholders who have ultimate control of listed German and Japanese companies, and the type of shareholders who ultimately control the majority of listed US, UK and Australian companies. The ultimate controllers of German and Japanese companies are "committed" shareholders: the evidence shows that they do not sell out in a crisis, but rather they stay put during (and sometimes become actively involved in) a rescue or restructuring of the stricken company (Edwards and Fischer 1994; Sheard 1989). However, institutional shareholders in US, UK and Australian listed companies have the option of doing the Wall Street walk: selling their shares. Indeed, one UK fund manager said in 1992 that there was "at least a 10:1 ratio" of sale over intervention at his institution (Black and Coffee 1994, p 2053).

None of the institutions reported that selling was a *first* instinct. Indeed, the converse appeared: all institutions reported that selling would generally be an option of last resort. Thus, one institution said: "We may sell after the battle's won or lost but not before the battle has begun. We'd rather stand up and fight than sell." Another institution reported it was constrained from selling by the requirements of indexing: "Tracking errors constrain how much one can deviate from the index, thus even active managers are required to hold big stock, eg, BHP and NAB, so one has to concentrate more on influencing a company rather than threatening to sell."

Three institutions said their investment style included buying into companies experiencing difficulty with a view to resolving that difficulty to improve the company and its share price. One of these institutions said: "If a fund manager perceives there is extreme value in a company which had not been unlocked because of some corporate governance issues, I think the attitude hardens far more towards activism or intervention than if it's a marginal case."

Similarly, another institution said: "It depends on your style as manager. If you've gone in as a growth investor and you think a company will grow faster than others and something happens to prevent that, you [sell and] go seeking the next growth stock. If you are a value investor, you buy cheap because there is a problem, and you have to deal with that problem to realise the value. If you're a passive investor, you're going to be in it anyway and it's got to be in your interest for the value of that stock to go up."[40]

Another institution said: "You buy a company because you like what the company is doing and you think it can do well. If there's an opportunity to influence them, you ought to do that rather than just dump the stock. Decisions to buy or sell are economically based, not morally."

Another institution said its attitude depended on the size of its holding and its consequent ability to influence the investee company: "There's a greater consciousness of good corporate citizenship these days and consequently the kneejerk reaction to sell is

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40 In regard to the final comment, see pp 27-28, above.

perhaps less prevalent. On the small cap side where you have the ability to actually be heard as a substantial shareholder, you have a better chance of actually making what you think is appropriate happen. With the larger stock, if you're not in a position to influence it, you may well sell the stock."

(2) Collective action and free-rider problems

Collective action and free-rider problems arise in the present context as a result of two key factors. First, any positive share price effects from monitoring or intervening will be enjoyed by *all* shareholders regardless of whether or not they participate in (or contribute to) the monitoring. Second, it is normal for the performance of fund management firms to be measured relatively rather than absolutely. That is, fund managers are assessed in comparison to the performance of their competitors or possibly an index. Taken in combination, this means that if one or two institutions spend resources intervening and (hopefully) increasing the value of a company's shares, their competitors who also hold shares in that company can free-ride on their efforts – their performance will improve along with that of the intervening institutions but they will have spent nothing in the process. For this reason, a rational fund manager will only spend time and resources on detailed monitoring or intervening at an investee company in limited circumstances.

The key pre-condition to intervening is the possession of an overweight holding in the stock.[41] Even though monitoring conducted by an overweighted fund manager would also benefit the performance of index-weighted and underweighted competitors, it would benefit the performance of the overweighted fund manager to a greater degree. Interviews conducted by Black and Coffee (1994) and Stapledon (1996a) have confirmed that UK-based fund managers do not participate in interventions when they have underweight holdings.

In the present study, institutions were asked whether they were conscious that their effective monitoring of investee companies became a collective good and that other shareholders, particularly other institutions, would take a free ride on their monitoring. Institutions were asked whether this acted as a disincentive against effective monitoring.

All but one of the institutions reported they were conscious of the collective good/free rider problem, but only one reported that it acted as a disincentive: "It's a bit of a disincentive. For example, the press was asking what we intended to do about the BHP board. Our attitude was that we're not going to carry the ball. We only hold 2 per cent, so why does it always have to fall on us?"

[41] A fund manager's index or market weighting in listed Australian equities is calculated as the market value of its total listed Australian equities under management divided by the market value of all listed Australian equities. A holding larger than index weight is an overweight holding, and a holding smaller than index weight is an underweight holding. A comparison of Tables 6.2 and 8.2 in Stapledon (1996a) reveals a considerable number of overweight institutional shareholdings in ASX All Ordinaries Index companies as at 1993.

The general attitude was that free riding occurred and there was nothing that could be done to prevent it: "Everybody tries to free ride on everybody else. That's what the market is about. It's just a factor in the investment equation." Another said: "[Free riding] is a problem; it's a fiercely competitively environment. But if it is actually going to result in better corporate structures and understanding of the issues, then maybe it's not such a bad thing." The competitive nature of the business was highlighted by another institution: "We work on the basis that we are not right 100 per cent of the time, and if someone wants to free ride, it's a risky business."

Two institutions saw free riding as a positive thing: "If you want to get your view across, the more the better. If you're going to do research anyway, there's no problem with it being widely disseminated."

(3) High cost of monitoring

Institutions were asked whether the high cost of effective monitoring of corporate governance issues of investee companies, in terms of money and resources, acted as a disincentive against their conducting that monitoring.

One institution specifically regarded the high cost as a disincentive: "We haven't quantified it, but it's got to be a disincentive. Even going to meetings would be a huge cost in terms of time away from the office for what is very little benefit in a lot of cases." Another institution doubted the benefit of monitoring: "It's not so much the cost but the cost versus benefit trade off. There doesn't appear, as yet, to be any special benefit in monitoring the way that certainly happens in the USA."

Generally, the other institutions admitted effective monitoring did come at a high cost, but considered it was a cost that could not be avoided. One institution said: "It's a cost we have decided to bear. Increasingly trustees of superannuation funds will count having a coherent corporate governance policy as a factor in hiring a fund manager." Another said: "Corporate structure and governance issues determine the future prosperity of investee companies, so they must be looked at."

(4) Potential conflicts of interest

Large institutional investors are likely to provide or offer to provide financial services to the companies in which they invest. For example, an institution which holds shares in an investee company might also manage the superannuation fund of that company, or another division of the same institution might provide insurance, banking or investment banking services to the investee company. Institutions were asked whether this impacted on any decision whether or not to intervene in the corporate governance of an investee company. That is, did a fear that the investee company may terminate the institution's services (as insurer, banker, etc) – on the basis that it was a meddling investor – act as a disincentive against the institution intervening? US studies indicate that this is a real issue. These studies of voting behaviour on anti-takeover proposals (generally found to be wealthdecreasing for shareholders) have found evidence of a bias towards pro-management voting by institutional investors having actual or potential business ties with the companies concerned.[42]

Three institutions said they did not supply other financial services to their investee companies, so the problem was not an issue for them, though two of them acknowledged its potential. One said: "We are not permitted to have external private-sector clients, but the problem may arise in the future."

One institution expressly conceded that the potential for a conflict of interest presently acted as a disincentive: "It's the obvious advantage of confidential voting. We need to create internal Chinese walls but that is not a particularly effective way of doing business. Good business is built on trust, and if you are having to do that stuff it detracts from the trust."

Several other institutions acknowledged some difficulties. One said that, where it was voting against a resolution and it had a client relationship with that investee company, "we would still do it but we would let them know". Another said: "We would hesitate before acting. We would try to keep the two separate. Realistically there would be occasions where there might be conflict."

One institution which was active in re-insurance said the potential conflict did impact directly on its relationship with client investee companies: "If one of our clients is a public listed company, and we also own shares in that client, then obviously there's a potential problem that, if we are critical on the share side, it might impact on the re-insurance side. We have to take a fairly commonsense approach and realise you are operating in one business and you have to temper your holdings or views because of the other side of the business."

Two institutions also mentioned the problem that might arise when an institution held shares in its parent company: "We are also shareholders in our parent, but the fiduciary duty overrides this and so we will implement normal policy." The other said: "We used to have a mandate that said you can invest in any shares except your own. We did not like that because sometimes we genuinely wanted to hold it."

Three institutions claimed that the fact they supplied other financial services to an investee company would not affect how they exercised the votes on behalf of their clients, with the fiduciary duty to the client being the overriding factor for one institution: "We are very concerned about what our duty is." Another said: "It shouldn't affect your judgment. We're quite happy to sell their shareholdings out and they're quite happy to change their [fund] managers from time to time."

C. Practical barriers

(1) Lack of information

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42 See Brickley, Lease and Smith (1988, 1994); Payne, Millar and Glezen (1995).

Where an institution intervenes at an investee company, the senior management and board of the company will have access to more material information than the institution. Institutions were asked whether the fact that they might not have all information impacted on their decision to intervene or not on a corporate governance issue.

None of the institutions said this factor influenced a decision to intervene or not. Indeed, three institutions said they would expect the board to have more information than they did: "You hope the board knows more about the company than you do; you'd be disappointed if they did not."

Three institutions said it might impact future relations with the board. One said: "If we felt information was being withheld, we would seek to have new directors installed next time." Similarly, another institution said: "If the board is doing something, we expect to be told the reasons behind it. Whether they are giving full information comes back to judging management by how well it does what it says it will do. They might try to pull a swiftie but they won't do it twice."

Generally the institutions said they would not even be aware of whether the board was withholding information from them or not: "Half the time we don't know. We can only decide on what information we have, and if that decision is not perfect because the information is not, that's [the company] management's fault and they deserve to be treated harshly."

(2) Difficulty of getting institutions to meet at short notice

Two institutions considered the logistical difficulty of getting institutions to meet at short notice, to discuss a problem concerning a company in which they held shares, did present a problem: "Everybody is busy, it's hard to get together. But if something is urgent enough, you make it happen." Generally the nine other institutions thought a meeting could be organised at short notice.

(3) Requirement to consult client

The institutions were asked whether any requirement to consult a client on an issue had inhibited their ability to act quickly when swift action was necessary.

Three institutions reported that a requirement to consult clients had inhibited taking swift action. One institution said this had had an impact, "particularly with public-sector clients where we can't exercise the vote without consent from their board. Generally their votes go dormant." Another institution had one client which it was required to consult: "It's a slow process because the client has to get a quorum together to discuss the issue and that slows down the whole process."

Five institutions said it was within their discretion whether clients were consulted beforehand in any case. One institution queried what issue required such swift action in the first case, pointing out that the Coles Myer issue evolved over the course of months.

VII. Analysis and conclusions

The findings of this interview study reveal a number of characteristics of institutional investors, and features of their involvement in corporate governance. They include:

- Institutions are not monolithic. Although they share similar views on some matters of general principle, different institutions commonly take different approaches to corporate governance issues. This reflects the fact that they are fierce competitors in the investment management industry.
- It is therefore not surprising that the level of enthusiasm for any particular best practice guideline in the AIMA Blue Book varies from one institution to the next. While the guidelines certainly appear to enjoy majority support, the lack of universal backing may partly explain why some corporate governance practices in listed Australian companies do not conform with the guidelines.
- Quite a few institutions still do not exercise their voting rights routinely – preferring to vote only on contentious issues or issues of major significance.
- Most institutions would not support any proposal to make voting mandatory for institutional investors. However, institutions are roughly evenly divided as to whether voting should be done on a confidential basis – to alleviate conflicts of interest.
- Most institutions maintain routine contact with the companies in which they hold shares. This contact is mostly at the CEO and senior management level, and only rarely involves non-executive directors. Some institutions believe that a dialogue with independent non-executive directors would be a useful addition to the corporate governance process.
- When institutions are dissatisfied with the performance or corporate governance of an investee company, they have three main options: sell the shares, intervene or do nothing. Reasons for intervening rather than selling commonly revolve around the share price. Either the institution’s shareholding is so large that it would be difficult to sell out all at once at a reasonable price; or the company’s shares are trading below the net tangible asset value; or the institution thinks that intervention will lead to an increase in the share price.
- The legal barriers to institutional investor activism considered most significant by institutions themselves – the minimum notice period for general meetings and the restriction on voting by unit trust managers – have decreased significantly since the 1 July 1998 reforms to the Corporations Law made by the Company Law Review Act and the Managed Investments Act.
- There are some economic and practical barriers to institutional investor activism – such as the cost of intervening, collective action and free-rider problems, potential conflicts of interest and lack of information. Several of the institutions that were interviewed downplayed the significance of these economic and practical barriers. However, the responses of the interviewees on these issues should be treated with a degree of caution, because this is an area where the best evidence is observed patterns of behaviour rather

than the views of the players. What do we find if we focus on actual behaviour? Two things stand out. First, a significant proportion of institutions still have a policy of not exercising voting rights on "routine" motions. Second, large-scale costly interventions have occurred infrequently in Australia – even taking into account the fact that this sometimes occurs entirely behind the scenes.

In conclusion, the increasing level of institutional share ownership in Australia is likely to see institutional investors continuing to play a significant role in corporate governance. However, there are limits to what can be expected from institutions. The economic and practical barriers just mentioned must be taken into account. Also, it must be borne in mind that there are several other forces at work in the area of corporate governance – including the market for corporate control (hostile takeovers, and the threat of hostile takeover), monitoring by independent non-executive directors and performance-based remuneration schemes for senior executives. That is, institutional investor activism is but one of several mechanisms which operate to align the interests of management and shareholders.

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