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**Abstract**

A recent exemption granted by the Australian Securities and Investment Commission enables institutional investors to cooperate to influence the corporate governance of the companies in which they invest. However, we are unlikely to see greater cooperation because only certain institutions qualify and the conditions to be satisfied to obtain the concession are onerous and apply for a strictly limited period. Apart from that, institutional investors in Australia have long been reluctant to actively involve themselves in the corporate governance of companies in which they invest for various reasons, including the free rider problem, political considerations, the insider trading provisions, the danger of being seen as a 'shadow director', and the nature of the competition between institutions.

**Keywords**

institutional investors, corporate governance, Class Order 98/649, Australian Securities and Investment Commission

# INSTITUTIONAL INVESTORS: WILL WE SEE GREATER COOPERATION BETWEEN THEM REGARDING CORPORATE GOVERNANCE?

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## Abstract

A recent exemption granted by the Australian Securities and Investment Commission enables institutional investors to cooperate to influence the corporate governance of the companies in which they invest. However, we are unlikely to see greater cooperation because only certain institutions qualify and the conditions to be satisfied to obtain the concession are onerous and apply for a strictly limited period. Apart from that, institutional investors in Australia have long been reluctant to actively involve themselves in the corporate governance of companies in which they invest for various reasons, including the free rider problem, political considerations, the insider trading provisions, the danger of being seen as a 'shadow director', and the nature of the competition between institutions.

## Introduction

The role of institutional investors in corporate governance issues is becoming more and more significant. The level of institutional shareholdings in listed Australian companies has increased to about 50% - due to factors such as compulsory superannuation[1] and the strong performance of equities markets compared to bonds.[2]

Similar increases have occurred in other countries such as the United Kingdom and the United States. For example, a recent study by two academics at Harvard University found that the role of institutional ownership had expanded

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1 More than 93% of Australians in employment are now covered by superannuation, compared with just 40% in 1984: 'Bernie's back with new super message', *The Australian* 24 February 1999, 27.

2 Ramsey I, Stapledon G and Fong K, *Institutional Investors' Views on Corporate Governance,* Centre for Corporate Law and Securities Regulation, University of Melbourne (1998) v. The authors of this research report interviewed representatives of twelve major institutional investors on their views on corporate governance issues - such as the role of independent directors, nominee directors, board nomination committees and remuneration committees; on the forms of their involvement in corporate governance - such as voting, monitoring and intervention; and on the barriers to institutional investor activism. It is interesting that only two institutions acknowledged that there had been any formal liaison with other institutions prior to taking action - though two others acknowledged that sometimes informal discussions and meetings did occur. Each of the twelve institutions had intervened in an issue of corporate governance in the preceding two years or so.

dramatically in the United States over the past two decades. The study reported that large institutional investors (a category including all managers with greater than US$100 million in discretionary control) had nearly doubled their share of the common-stock market over the 1980 to 1996 period. By December 1996, they controlled over half of the market.[3] The study also found that the concentration of institutional ownership, measured by the fraction of individual firms' equity held by their five largest institutional blocks, has increased as rapidly as overall institutional ownership. In December 1980, the ten largest institutions exercised discretionary control over 4.3 percent of the common-stock market and the one hundred largest institutions held 16.7 percent. By the end of 1996, these fractions had increased to 14.4 percent and 36.7 percent respectively.[4] The growth in institutional investment was thus primarily driven by increases in the holdings of the largest institutions. In the United Kingdom, institutional investors have increased their market share of listed equities to over 60%.[5] These increases must have implications for large shareholders as monitors of corporate governance, yet corporate law seems to have largely ignored this development and its potential impact on the concepts of ownership and control.[6]

The separation of ownership (the shareholders) and control (management) in the large modern corporation, and the problems it raises, has been much discussed. Several mechanisms that compensate for this separation are now recognised, such as the fiduciary duty laws, the market for corporate control, mandatory disclosure requirements, minority shareholder protection, incentive compensation, independent directors and, importantly, pressure from large shareholders. None of these mechanisms provides a complete answer but it appears that shareholder activism has become a more important disciplining mechanism in the United States over the last ten years. Large public pension funds, such as the California Public Employees Retirement System (CalPERS)[7], have put pressure on boards and management of underperforming firms to

3 Gompers P and Metrick A, 'How are Large Institutions Different from Other Investors? Why do these Differences Matter', *Social Science Research Network Electronic Library,* downloaded on 6/11/98 from http://papers.ssrn.com. In carrying out their analysis, the authors employed data from the SEC filings required of all institutions with over US$100 million under discretionary management. The study finds that large institutions show a strong preference for large, liquid stocks - with some evidence that they also prefer characteristics associated with prudence, value, and low past returns.

4 Gompers and Metrick, above n 3, 8.

5 Farrar J H and Hannigan B, *Farrar's Company Law* (4th ed) Butterworths, London (1998) 578.

6 Though there has been significant academic discussion and research dating back a few decades; see eg Harbrecht P, *Towards the Paraproprietal Society* (1960) and 'Pension Funds and Economic Power: The Paraproprietal Society', preface to Baum D J and Stiles N B *The Silent Investors* (1965). See also Farrar J H and Russell M, 'The Impact of Institutional Investment on Company Law' (1984) 5 Co Law 107. For thorough recent studies, see Stapledon G P *Institutional Shareholders and Corporate Governance* (1996) and Monks R A G and Minow N *Corporate Governance* (1995) 120-177.

7 Smith M, 'Shareholder activism by institutional investors: Evidence from CalPERS', (1996) 51 *Journal of Finance*, 227-252. This study found that 72 percent of the firms targeted by CalPERS, in the sample period, adopted proposed governance changes or made changes resulting in a settlement with CalPERS. Interestingly, it also found that shareholder wealth increased for firms that adopted or settled and decreased for firms that resisted.

improve their performance or lose shareholder votes.[8] Recent studies have found that activist shareholders in the United States are likely to purchase large blocks in highly diversified, underperforming firms.[9] It seems that the value of intervention is greatest for these kinds of firms and there is thus a greater incentive to acquire a large block of shares.

This increased activism is partly because it has become more difficult for institutions that are unhappy with the corporate governance of a company simply to sell the investment ('do the Wall Street walk').[10] Because of the substantial size of many of the shareholdings, it will often not be possible to sell the holding quickly and also obtain a reasonable price. Furthermore, the shares may be trading below the company's asset backing (possibly due to the very conduct about which the institution is unhappy) and this may mean that selling is not an attractive option.[11] The ability of index funds to sell may be limited by the extent to which they can depart from the index. On the other hand, some institutions are so-called value investors and may deliberately buy into a company experiencing corporate governance (or other) problems with the intention of fixing those problems.[12]

The result of all these factors is greater pressure on institutions to become involved and to do something when there are problems with the corporate governance of the companies in which they invest. A recent example of this was provided in Australia by the managing director of Perpetual Trustees who said that shareholder activism was on the rise, driven by access to wider sources of information and more intensive questioning of performance. He added that: 'We

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8 Latham M, *The Corporate Monitoring Firm*, 5, downloaded from www.corpmon.com on 11 February 1999. Latham argues that shareholders can gain effective control over their firm's management by voting to choose an outside agency to nominate director candidates. He proposes a system for shareholders to choose directly among competing nominating agencies, without interference from management. These nominating agencies would need to monitor director performance to decide whether to nominate a given candidate again. This proposal seems to have some merit as it would enable shareholders to make monitoring decisions with minimal information costs - thus avoiding the free-rider problem. Latham states (at 9) that 'the changes advocated promise to shift more of the fruits of capitalism from a management elite to the population of working people and retirees'. If such a system were ever introduced, it could diminish the importance of institutional shareholders as a monitoring mechanism. See also Gilson R J and Kraakman R, 'Reinventing the Outside Director: An Agenda for Institutional Investors', *Stanford Law Review* (1991) 43:863.

9 Bethel J E, Liebeskind J P and Opler T, 'Block share purchases and corporate performance' (1998) 53 *Journal of Finance*, 605-634.

10 Apart from the practical difficulties mentioned here, the tendency of institutions to simply sell their investment in times of trouble has been criticised as denying the existence of any duty to fellow shareholders and other groups such as employees and consumers: see, eg, Farrar and Hannigan, above n 5, at 580.

11 Ramsay, Stapledon and Fong, above n 2, at viii.

12 Latham, above n 8, at 9, points out that large shareholders are a mixed blessing to the small shareholder: 'They may undertake costly monitoring of management, to the benefit of all owners. They may pay a premium to buy out all the shares. But they may extract value from the firm to the detriment of other owners, such as by receiving greenmail, 'white knight' deals, inside information, or by in effect joining the management team and benefiting in various ways from non-arm's-length transactions with the firm.'

at Perpetual believe that, as an institutional investor, we are negligent if we do not use our rights and powers to improve investor returns.'[13]

However, there are various provisions of the Corporations Law that may act as barriers to institutional investor activism. Examples of these are the insider trading provisions, the 'shadow director' provisions, and the control aggregation ('takeover') provisions. It is the last mentioned provisions that are the focus of this paper as the Australian Securities and Investment Commission has recently indicated its willingness to relax the application of these provisions to institutional investors.

## The impact of intervention by institutional investors

Whilst there is no doubt about the rise in institutional shareholdings, there seems less certainty about the impact that this has had on corporate governance and corporate performance. A recent review of empirical studies in the United States found that the studies were inconclusive: some indicated that institutional investor activism had had a positive impact on corporate performance but others indicated that it had had a negative impact or no apparent impact at all.[14] Research is currently being conducted on this issue by the Centre for Corporate Law and Securities Regulation in conjunction with the Department of Accounting and Finance at the University of Melbourne.[15] However, one of the problems of measuring the effect of institutional activism is that it will often take place behind the scenes. [16]

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13 Gluyas R, 'Go gently into brave new dawn', *The Australian*, 24 February 1999, 22. As an example, he mentioned that his institution had lobbied several companies about returning to investors the benefits of unused franking credits. For a discussion of the duty of trustees and other fiduciary office-holders to give real consideration to the exercise of their powers, see Stapledon G P, 'The Duties of Australian Institutional Investors in Relation to Corporate Governance' (1998) 26 *Australian Business Law Review* 331.

14 Black B S, 'Shareholder Activism and Corporate Governance in the United States' in Newman P (ed), *The New Palgrave Dictionary of Economics and the Law*, Stockton Press, New York (1998) vol 3, 459. See also Coffee, J C, Jr. 'The Folklore of Investor Capitalism' *Michigan Law Review* (1997) 95, 1970 (book review of Useem M, *Investor Capitalism: How Money Managers are Changing the Face of Corporate America*, 1996, New York: Basic Books). Coffee states (at 1976) that: '[I]t may be shortsighted to assume that institutional investors are powerful simply because they are large. This assumption mistakenly equates an ox with a bull.' He goes on to discuss the the possible explanations for institutional impotence and the evidence that management has in fact become more entrenched in the United States in recent years by mechanisms such as poison pills and staggered boards.

15 The Chief Investigators for the project are Professor Kevin Davis, Professor Ian Ramsay and Dr Geof Stapledon and the project is titled 'The Impact of Institutional Investors on Capital Markets and Corporate Performance': Ramsay, Stapledon and Fong, above n 2, at 4.

16 See, eg, Carleton W T, Nelson J M & Weisbach M S, 'The Influence of Institutions on Corporate Governance through Private Negotiations: Evidence from TIAA-CREF', (1998) 53 *Journal of Finance*, 1335. The authors analyse the correspondence between a major institution (the Teachers Insurance Annuity Association – College Retirement Equities Fund) and 45 firms it contacted about governance issues between 1992 and 1996. This correspondence indicates that the institution was able to reach agreements with targeted companies more than 95 percent of the time. In more than 70 percent of the cases, this agreement was reached without shareholders voting on the proposal.

The most often cited matter in which institutions have intervened in recent years in Australia has been the Coles Myer controversy where some institutions became concerned about various matters including potential conflicts of interest on the Coles Myer board.[17] Institutions have also, for example, intervened to object to a proposed restructure of a board, or to a particular transaction that the company proposed to enter into, or to express concerns about executive share option schemes or the level of benefits being given to non-executive directors. Apart from actual intervention, there is direct and indirect industry-wide and firm-level monitoring. Direct monitoring includes the analysis of information as well as meetings with management. Indirect monitoring would, for example, include the support of non-executive directors.[18]

In spite of all that has been said so far, it appears that collective action by institutional investors is relatively rare in Australia and in the United States – even though it could be argued that it is precisely through coalitions that institutional investors could maximise their political and economic clout.[19] This contrasts with the United Kingdom, where institutional investors apparently often approach a company jointly to increase their influence.[20]

## The effect of the control aggregation provisions in the Corporations Law

One of the reasons for the reluctance of one institution to liaise with another (particularly the reluctance to do so formally) has been a fear of triggering the takeover provisions or, more accurately, the 'control aggregation provisions' in the Corporations Law.

The ambit of these provisions is wide and they may apply to circumstances where there is no takeover taking place. The provisions are based on the concept of entitlement to shares, which essentially is defined as your relevant interest *as well as your associates' relevant interests.*[21] The danger that an institution faces in liaising with other institutions is that the other institutions

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17 Ramsay, Stapledon and Fong, above n 2, at 25-28. This matter was covered extensively in the financial press. For a recent reference see Gluyas R, 'Lew on prowl with $2bn in war chest', *The Australian,* 23 February 1999, 21. Particularly controversial was the so-called Yannon transaction in 1990, which effectively involved the transfer of $18 million in losses from the chairman's private interests to Coles. The then chairman, Mr Solomon Lew, has denied any wrongdoing but the transaction remains under investigation by ASIC. After a revolt by Coles's institutional shareholders, Mr Lew surrendered the chairman's position in 1995 but remained a director.

18 Farrar and Hannigan, above n 5, at 579-580.

19 Coffee, above n 14, at 1977

20 Black, above n 14, at 461.

21 See s609 of the Corporations Law. Institutions will generally hold a relevant interest in the shares of companies in which they invest - because they will have power to vote in respect of the shares and power to dispose of the shares: s31. They will also hold a relevant interest in shares if they have power to control the exercise of voting rights attached to those shares: s30(2), s30(3) and s31(1). This could arise where some institutions agree to vote their shares in a particular way. For example, one institution could compel another to comply with that voting agreement by obtaining a court order. See *Issues Paper - Collective Action by Institutional Investors,* ASC, (1996).

may become its 'associates'[22] so that their relevant interests in shares would then have to be added to those of the first institution. This may have the effect of increasing the entitlement of the institution to the shares of a particular company. This could then trigger the provisions in the Corporations Law that are based on entitlement, such as the substantial shareholding provisions in Part 6.7 of the Corporations Law. These provisions require anyone who is entitled to five per cent or more in a listed company to notify the company of the substantial shareholding and of certain subsequent changes to the holding.[23]

Another important provision that is based on entitlement and may thus be triggered is contained in section 615 of the Corporations Law. This section prohibits a person from acquiring shares in a company (except as provided by Chapter 6) if any person would, immediately after the acquisition, be entitled to more that 20 per cent of the voting shares in the company.[24] If the other person was already entitled to more than 20 per cent, then the acquisition is prohibited if it would increase that person's entitlement. Chapter 6 does lay down various exceptions and methods by which such acquisitions may be made. Usually, a formal bid would have to be made for all the outstanding shares in the company.

These provisions could have the unintended consequence of deterring institutions from actively participating in corporate governance issues and it is to prevent this that ASIC has provided relief.[25] Although the relief is of a restricted nature, it is a recognition by ASIC that the objective of Chapter 6 is to regulate the acquisition of shares in a target company for valuable consideration when the acquirer desires to obtain (or increase) control of the target.

## Relief provided by ASIC

Due to these potential pitfalls, the Australian Securities Commission (as it then was) issued an Issues Paper for public comment in November 1996.[26] It proposed granting conditional relief to enable institutions to liaise with each other and to enter into an agreement to vote collectively at particular company meetings.

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22 Under ss12 or 15 of the Corporations Law. If institutions enter into agreements (or even propose to enter into agreements) to vote or take action together, or to act in concert with each other, they will usually become associates.

23 If the institution is already a substantial shareholder and increases its entitlement by 1% or more, it has to lodge a substantial shareholder notice as well.

24 A contravention of s615 requires both an increase in entitlement over 20% and an acquisition of shares. However, acquisition is broadly defined in s51 of the Corporations Law to include acquiring a relevant interest in shares as a result of a transaction. If the agreement leads to the institutions acquiring relevant interests in each other's shares, this would thus be regarded as an acquisition of the shares and may lead to a breach of s615. Even if the agreement does not lead to a breach, it may prevent the institution from acquiring further shares in the company.

25 In a media release dated 21 November 1996 ('ASC Seeks Comment on Collective Action by Institutional Investors') it is stated that 'the ASC has moved to try and ensure that the regulatory regime does not inappropriately influence the decision of institutions whether to participate in corporate governance issues or to divest their holdings'.

26 *Issues Paper - Collective Action by Institutional Investors,* ASC (1996). This paper is available on the ASIC website at http://www.asic.gov.au.

These concessions were subsequently introduced by way of a Class Order, which the Commission published in May 1998.[27] The Class Order applies automatically when its conditions are satisfied.[28]

**To what kind of liaison does the Class Order apply?**

ASIC acknowledges that it is possible for institutions to discuss issues which will, or may, be the subject of a vote at a meeting without entering into a relevant agreement[29] that might be caught by Chapter 6. Although it may be difficult to draw the line, ASIC believes that, generally speaking, to persuade a person to follow a course of action in relation to voting shares does not involve an acquisition; but to persuade that person to *undertake* to follow such a course of action may well be to acquire the shares.[30]

ASIC specifically considers that institutions will not have entered into a relevant agreement about voting if they limit their action to the following:

(a) holding discussions or meetings about voting at a specific or proposed meeting of a company;

(b) discussing issues about the company, including problems and potential solutions;

(c) discussing and exchanging views on a resolution to be voted on at a meeting;

(d) disclosing individual voting intentions on a resolution; or

(e) recommending that another institution votes in a particular way.

On the other hand, ASIC will consider parties to have entered into a relevant agreement if any of the following occur:

(a) any institution accepts an inducement to vote or act in a specific way regarding the disposal of shares;

(b) there is an arrangement under which one institution expects another institution to act in a certain way regarding voting or disposal of shares;

(c) agreement on a plan concerning voting or disposal of shares; or

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27 *Class Order 98/649: Collective Action by Institutional Investors,* ASC 1998 issued on 8 May 1998.

28 Consequently, ASIC does not undertake a merit review of the proposed collective action or endorse the institutions' proposed action: *Issues Paper,* above, 4.

29 'Relevant agreement' is defined in s9 as an agreement, arrangement or understanding, whether formal or informal, whether written or oral, and whether or not having legal or equitable force.

30 See, generally, *Policy Statement 128: Collective Action by Institutional Investors,* which was issued on 14 January 1998 and updated on 8 July 1998.

(d) an institution limits its freedom to vote or dispose of shares.

If institutions are unsure whether their proposed conduct will be caught by Chapter 6, they would probably be well advised to comply with the terms of the Class Order. ASIC has made it clear that it will consider enforcement action against institutions that act collectively in breach of the Corporations Law or outside the terms of the Class Order.

**To what kind of institution does the Class Order apply?**

The Class Order applies to an institution whose primary functions are to:

(a) pool the funds of persons to whom the institution owes a fiduciary duty, or a contractual duty under a life insurance policy; and

(b) invest the funds in any of the following:

- (i) a prescribed interest scheme for which there is an approved deed or a registered managed investment scheme[31];
- (ii) a regulated superannuation fund, an approved deposit fund, a pooled superannuation trust or a public sector superannuation scheme within the meaning of the Superannuation Industry (Supervision) Act 1993 (Cth)[32]; or
- (iii) a statutory fund of a registered life insurance company within the meaning of the Life Insurance Act 1995 (Cth).

The Class Order is restricted to this type of investor because generally the objective of these types of institutions is to manage funds on behalf of persons to whom they owe a fiduciary duty. As they normally do not seek control of the companies in which they invest, ASIC considers that there is less risk of these institutions using a voting agreement as a covert way of obtaining control of a company in a way that is contrary to the principles expressed in ss731 and 732 of the Corporations Law. These are the so-called Eggleston principles, which essentially aim to achieve fairness and ensure that shareholders are adequately informed when a corporate takeover takes place.[33]

ASIC has retained discretion to extend the Class Order if it is persuaded to do so. Persons wanting the Class Order extended to include them can make a request to any ASIC Regional Office.[34]

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31 The latter exist since the commencement of the Managed Investments Act 1998.

32 The Class Order incorrectly refers to the Superannuation Industry (Superannuation) Act 1993 (Cth).

33 So named after the chairman of the committee which laid down these principles, Sir Richard Eggleston: see the *Second Interim Report of the Company Law Advisory Committee* (AGPS, 1969).

34 This extension appears to be limited to bodies corporate. Applications must include documentation supporting the applicant's view that it should be given relief because it falls within the policy of the relief. The applicant must demonstrate to ASIC that it (a) invests funds on behalf of persons to whom it

**Requirements to obtain relief**

The relief in the Class Order is only available when:

(a) the agreement is publicly announced in the prescribed manner;

(b) no consideration (other than a promise to exercise a vote in a particular way) passes between any of the relevant institutions or other parties in connection with, or as a result of, the agreement;[35]

(c) the agreement relates to voting in a particular way, on a particular issue, or abstaining from voting, at a specified or a proposed meeting of a company in which the institutions have a relevant interest in the voting shares of that company;[36]

(d) any party to the agreement is able to terminate its participation in the agreement at will;

(e) the agreement specifies that it will terminate at the close of the relevant meeting;

(f) an institution would, but for the operation of the Class Order, have an entitlement to 5% or more of the voting shares of the company whose meeting is the subject of the voting agreement; and

(g) the parties to the voting agreement would not, apart from the Class Order, be collectively entitled to 20% or more of the voting shares in the company which is the subject of the voting agreement, excluding shares which are:

  (i) held by a party to the agreement, or its associate, on trust for, as agent of, on behalf of or for the benefit of persons to whom the party owes a fiduciary duty; or

  (ii) held for a statutory fund for a registered life insurance company in respect of investment-linked products.

These requirements are all straightforward with the possible exception of the last one, which did not appear in the Issues Paper. It did appear in the Policy Statement but was worded differently, namely that 'the parties to the agreement

owes a fiduciary duty, and (b) does not hold shares in the company for the purpose of obtaining or increasing control of that company. The application must be lodged in enough time for ASIC to consider the matter and for the agreement to be publicly announced at least one week before the company's meeting (or a shorter period if ASIC agrees).

35 S41 of the Corporations Law allows the relevant interests that persons acquire when they are given, for no consideration, a proxy to vote at a meeting of members to be disregarded. To a limited extent, this already allows institutions to achieve collective action.

36 This requirement flows from the definition of 'voting agreement' in the Class Order.

are not collectively entitled to 20% or more of the voting shares in the relevant company, as principal'.

The wording was presumably changed because the concept of being *entitled* 'as principal' does not make sense as 'entitled' by definition includes one's associates' relevant interests. The Policy Statement did not define this concept but it did state that shares *held* 'as principal' meant shares held by an institution:

(a) on its own or its associates' account; and

(b) *not* held on trust for, as agent of, on behalf of or for the benefit of persons to whom the institution owes a fiduciary duty.

The policy appears to be to exclude institutions which might use the Class Order 'as a means of increasing their control of the company'[37] but there is, of course, not necessarily any similarity between 'entitlement' and 'control'. The later wording in the Class Order itself thus seems preferable.

37 Policy Statement, above n 30, at 128.17.

**The public announcement**

As mentioned above, one of the conditions for relief is that a public announcement must be made.[38] This is in accordance with the philosophy of disclosure underlying the regulation of securities markets, namely that full and timely disclosure ensures that shareholders and other market participants receive all material information on which to base their investment decisions.[39]

The announcement must contain the following:

(a) the names of all the institutions which have entered into the voting agreement;

(b) the name of the company which is the subject of the voting agreement;

(c) the date and time of the meeting (if known - otherwise a specific description of the meeting, eg the next annual general meeting of XYZ Ltd);

(d) a summary of the matter to be voted on;

(e) a summary of the objective of the action and how the institutions propose to vote; and

(f) the relevant interests in the company held by:

    (i) each institution; and

    (ii) the institutions collectively.

The parties must make the announcement at least seven days before the day of the meeting. If the company is listed, the announcement must be made to the ASX before 9.30am on the next business day after the day that the voting agreement was entered into. If the company is not listed, the parties must place an advertisement in a national newspaper as soon as possible. A copy of the announcement has to be sent to the company as well - before 9.30am on the next business day after the voting agreement was entered into. Institutions wishing to enter into an agreement less than seven days before the meeting can apply to have the Class Order extended to them. The Commission may grant relief if it considers that the market and the board of the company would have adequate time to react to the public announcement.

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38 Knowledge of the voting agreement and its contents is likely to be price sensitive information. If this is the case, the parties will have to cease trading until the announcement has been made known and a reasonable period for it to be disseminated has elapsed. See the definition of 'information generally available' in s1002B.

39 *Issues Paper*, above n 26, at 4.

While the Class Order relief applies to it, each institution must also disclose:

(a) changes greater than 1% in the relevant interests it holds in the company; and

(b) changes greater than 5% in the relevant interests in the company held collectively by the parties to the agreement.

These changes must similarly be announced before 9.30am on the next business day after the institution becomes aware of the changes, or advertised in a national newspaper as soon as possible. One institution may make these announcements on behalf of all parties to the agreement.

### Consequences of a contravention

If the provisions of the Class Order are contravened, ASIC has various possible grounds for taking action. It may, for example, take action under s995 (if the behaviour amounts to misleading or deceptive conduct); s999 (if there have been false or misleading statements about securities); s1002G (if a person trades in securities while in possession of inside information or otherwise contravenes that section). If an institution does anything, which is not within the spirit of the relief, ASIC is likely to consider that unacceptable circumstances have occurred and may refer the matter to the Corporations and Securities Panel.

## Likely reaction of Institutional Investors

So, are we likely to see more consultation between institutional investors regarding the corporate governance of investee companies and greater liaison regarding intervention?

### Their own views

The survey of twelve major institutional investors conducted by Ramsay, Stapledon and Fong took place after the release of the Issues Paper but before publication of the Class Order. Consequently the institutions were asked their views on the proposals as contained in the Issues Paper. Eight (of the twelve) institutions indicated their support for the proposals in the Issues Paper but this support was not unqualified. One institution expressed the concern that the Commission might allow action that was personally motivated and not objectively based. Another criticised the wording as being very cumbersome. ‘You are required to declare exactly what your conversation was about. It’s ridiculous that shareholders can’t talk to one another.’[40] This concern will not have been lessened by the detailed requirements of the actual Class Order as discussed earlier.

40 Ramsay, Stapledon and Fong, above n 2, at 29.

Another institution expressed its concern about the continued lack of clarity about what institutions may do before they breach the takeover provisions. It criticised the Issues Paper for requiring institutions to nominate whom they were seeing and to ask for special arrangements when what they really wanted was the ability to speak to each other. '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.'[41]

The drafting of the eventual Class Order and Policy Statement may, to some extent, alleviate the last concern. As mentioned above, ASIC has given some indication of the kind of conduct which it will not regard as involving a relevant agreement and this includes discussing and exchanging views on a resolution to be voted on at a meeting. But institutions will still have to be careful not to overstep the mark.

Other concerns expressed were that there seemed to be a special concession to institutions that wasn't there for other shareholders and that the concessions may be used to get around the 20 per cent rule (that is, the takeover threshold). The first concern seems to miss the point that most other shareholders are unlikely to have sufficient shares between them to trigger the takeover provisions even if they are deemed to be associates of one another. The second seems to be concerned that some institutions may use the concessions to obtain control of a company without having to make a formal bid to all outstanding shareholders. This seems to fly against the other concerns about the limited nature of the concessions.

**Competition amongst institutions**

A factor that may well place a limit on the use that is made of the Class Order is the competitive nature of the industry. Fund managers are generally assessed in comparison to the performance of their competitors. If an institution takes action (at its own expense) which results in an increase in the share price of a company, that benefit is enjoyed by all shareholders - including its competitors who have not incurred the costs. This is the so-called 'free-rider' phenomenon, which may deter an institution from incurring the costs associated with monitoring and intervening in an investee company. If, however, the institution has an overweight holding in the stock of the investee company, it would benefit from the intervention by a greater degree than its competitors. So, it may be stated that an overweight holding is an important precondition to intervention.[42] Earlier research established that there is a considerable number of overweight institutional shareholdings in the ASX All Ordinaries Index companies.[43] This

41 Ibid, at 30.

42 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. An overweight holding is a holding that is larger than the index weight. See Ramsay, Stapledon and Fong, above n 2, at 35.

43 Stapledon, *Institutional Shareholders and Corporate Governance,* Oxford University Press (1996), tables 6.2 and 8.2.

would seem to indicate that we will be more likely to see institutional liaison concerning the companies included in this index.[44]

Theoretically, at least, the fact that institutions may now enter into voting agreements should reduce the effect of competition amongst institutions as a limiting factor. Such agreements spread the costs and thus reduce the free-rider problem.

### More likely to be shadow directors?

Another factor for institutions to consider is whether increased cooperation (and the increased control that accompanies it) may make the institutions more likely to fall within the definition of 'shadow director' in section 60(1)(b) of the Corporations Law. This section defines the term 'director' to include a 'person in accordance with whose directions or instructions the directors of the board are accustomed to act'. Falling within the definition would bring with it potential liability for breaches of directors' duties and the insolvent trading provisions of the Corporations Law.

### Political consequences

Institutional investors have in the past been restrained by a concern about the possible political consequences of an exercise of power.[45] They wish to avoid public criticism and the intervention this may lead to. Related to this is a reluctance to offend the investee companies as this may contribute to political pressure or disturb other business relationships. This reluctance of institutions to exercise their voting power has been criticised in the past as it 'means that the directors and managements of the corporations whose stock they hold become increasingly self-appointed and unchallengeable'.[46]

The concessions announced by the Australian Securities and Investment Commission may well embolden institutions in this regard. If they are able to collaborate with each other and form a united front, this would deflect possible political pressure and make commercial sanctions more difficult.

## Conclusion

The Class Order thus enables two or more institutions which hold shares in a company to enter into an agreement about voting at a meeting of that company. Institutions will not have relevant interests in, or be entitled to, each other's voting shares in the company, or become associates in relation to the company,

44 The ASX is proposing changes to the structure of the All Ordinaries Index, partly due to the recent emphasis on market indices as benchmarks for investment mandates. The relevant consultation paper is available on the internet at the ASX home page: www.asx.com.au.

45 Farrar and Hannigan, above n 5, at 580.

46 Berle A, *Power without Property*, Harcourt Brace and Co (1960) 56.

merely because they have entered into a voting agreement - provided the agreement is covered by the Class Order. The relief is limited in that it applies only from the time that the institutions enter into the agreement until the close of the meeting. Institutions that comply with the terms of the Class Order will not have to lodge substantial shareholder notices about changes in entitlement which arise solely because of the agreement.[47] Furthermore, s615 will not restrict trading in the shares of the company by parties to the agreement because of relevant interests and entitlements arising from the agreement.[48]

The Class Order is designed to allow institutions to enter into voting agreements when those agreements are specific and short term, and no consideration passes.[49] The reasoning is that agreements of this type are not steps towards the purchase or sale of control of a company. If the institutions comply with the terms of the Class Order, their agreement will not make them associates and they will not be deemed to have acquired each other's shares under the Corporations Law. The Class Order is clearly intended to permit cooperation between institutional investors. However, we are unlikely to actually see greater cooperation as the concession is strictly limited and the conditions to be satisfied are onerous. Furthermore, institutions have traditionally shown a reluctance to actively involve themselves in the corporate governance of the companies in which they invest.[50]

The fundamental question remains to what extent company law should adapt so as to redefine the role of controlling shareholders in general and institutional shareholders in particular.[51] Should increased legal responsibilities accompany the increasing exercise of their power by institutional investors? The impact on corporate governance of the relationship between the institutions, the investee companies and the beneficial owners of the shares needs to be further explored and considered.

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47 The reasoning is that the market will be adequately informed because of the information required to be disclosed in the public announcement. However, it is important for institutions to remember that, to ensure that the market remains informed, the Class Order requires the institutions to announce changes to their individual and collective relevant interests during the time that the relief applies.

48 However, each party will have to comply with s615 as regards relevant interests and entitlements arising outside the agreement, and the insider trading provisions will still apply.

49 Policy Statement, above n 30, at 128.11.

50 This conclusion seems to be borne out by phone calls to the offices of the Australian Stock Exchange as well as ASIC during May 1999. Staff in the relevant departments were unaware of any announcements having been made under the Class Order.

51 Farrar and Hannigan, above n 5, at 582.