Submission to the Parliamentary Joint Committee on Corporations and Financial Services: ***Inquiry into shareholder engagement and participation***

Submission by Professor Margaret Nowak (Director) and Dr Margaret McCabe (Principal Researcher)
Governance and Social Responsibility Research Unit
Graduate School of Business
Curtin University of Technology.
78 Murray Street
Perth WA 6000

Terms of Reference 1 - barriers to the effective engagement of all shareholders in the governance of companies.

For retail shareholders barriers to engagement are created because of the relatively low average value of individual holdings, and the cost of and access to information. On the other hand it can be argued that institutional shareholders face lower information costs relative to returns and have greater opportunities for specialisation in relevant information. We do, however, argue that a move to direct voting may invigorate shareholder engagement and can be supported on other grounds.

ASX research in 2006 (2006 Australian Share Ownership Study) found that just under six million Australians owned shares directly. The proportion of the population owning shares in a listed company fell to 38% in 2006 from 41 % in 2004. Their research suggests this fall was the result of realignment of portfolios towards property. However, those remaining in the market have broader holdings and have increased knowledge about shares and increased trading activity relative to 2004 research findings.

The ASX research has identified that approximately one third of direct investors are confident investors, making regular trades on the market (an average of 21 p.a.) and on average holding a portfolio in 2006 valued at over $300,000. The remaining two thirds of direct investors make on average only one to three trades per year and their average portfolio is in the range of $100,000.

Retail investors account for only a small proportion of the total market (18% by value of share trades in 2003).For retail investors, especially that group with portfolios of $100,000 or less, the barriers to effective engagement in the monitoring of the governance of companies are substantial. Cost (especially in time) relative to the benefits from accessing and analysing comparative industry and market information to make judgments on relative firm performance, is a major factor. ASX research shows that direct investors spread their portfolio across industry sectors and that 40% have a spread across three or more sectors. This compounds the cost of acquiring and analysing the information to facilitate active engagement. Lack of ready access to ‘briefings’ by top executives and investor relations managers, cost of orchestrating any intervention which will be heard at an AGM and difficulty in engaging in any meaningful way in the selection and election of board directors are also factors.

We would question whether active engagement by retail shareholders is ever a reasonable expectation and have argued (Nowak & McCabe 2006) that ‘for the retail

investor 'rational' apathy in relation to governance performance…is often optimal. Exit from the corporation via sale of shares, remains their most effective option when dissatisfied…'. Nevertheless, we consider that some change to existing procedures around the AGM could invigorate retail shareholder engagement.

i) *A move to direct voting by shareholders.* The rationale used to support the status quo in relation to voting either directly in person at the AGM or by proxy, viz. that shareholders then can hear the discussion at the meeting prior to the final decision on their vote, does not stand up to scrutiny. Except for those able to attend, proxy decisions are made without benefit of that discussion. It does, however, excuse corporations from providing adequate information on resolutions ahead of the meeting. The provision of adequate information to enable informed decisions on resolutions ahead of the meeting is the issue here.

A move to direct voting has been supported by the Chartered Institute of Secretaries (Discussion Paper, March 2006) and discussed as an important option by the report of the Companies & Securities Advisory Committee (2000) on Shareholder Participation in the Modern Listed Public Company. The implementation of direct voting requires that the company constitution provides for a member to cast a direct vote. It does not appear to require Corporations Act amendment. Two companies, Telstra and AFIC have already taken steps towards direct voting (Simon Hoyle, Sydney Morning Herald, 4/09/07) while the NRMA has provided for direct election of directors for some years. However, encouragement for corporations to undertake the amendment to their constitution will be important and may be achieved through amendment to *best practice guidelines*.

ii) *Requirement for objective information on resolutions to be provided ahead of the AGM and voting decisions*. In particular best practice provision of information on director candidates would include some objective data about other directorships held, attendance record (if to be re-elected), committee memberships, related industry experience and relevant professional expertise, years as a director of the company and a statement by the director supporting their election. This is not a big ask and would give at least some information as the basis for shareholder decision. At present there is often no information beyond the named person who is nominated or has been renominated.

.

Terms of Reference 2 - whether institutional shareholders are adequately engaged, or able to participate, in the relevant corporate affairs of the companies they invest in.

Our research shows that many institutional investors are engaged; the decision to participate and the nature and extent of their participation, however, depends on the relative size of their investment stake and the policy of the individual institutional investor towards engagement.

There is an argument that active monitoring and engagement by institutional investors may be an effective substitute for activism by retail shareholders and can lead to more informative prices, increased liquidity and lower monitoring costs for all investors (see Nowak and McCabe 2006 for elaboration of this position). Institutional investors will, by the nature of their business, have more specialised resources (analysts) available to undertake monitoring and analysis of individual company and industry performance. They are also a focus of attention from corporate investor relations specialists. As a result of their specialisation in corporate information collection and analysis institutional

investors are expected to be informed market participants and this in turn is expected to lead to informative prices and improved market liquidity, of advantage to all investors.

Our research shows that, if they wish to exercise it, institutional investors can have direct engagement in (or relationships with) the companies they are invested in. This enables institutional investors to exercise their 'voice' through dialogue and informal influence at board or executive level without change in control in the company (see Nowak and McCabe, 2006, for further discussion). This is achieved through access to and relationships with corporate executives and in some instances the board, visits and informal discussions and formal communications, the latter where there is dissatisfaction with corporate directions. Nevertheless the calculation for the institutional investor remains one of balancing the information and transaction costs of active engagement against the benefits of doing so. The benefits are more likely to outweigh the costs of engagement where their holding of shares in a particular corporation is significant in the context of their portfolio and/or overall market trading volumes in that corporation. Nevertheless our research finding was that a number of institutional investors adopted a policy of non-engagement and the proponents of this approach argued that engagement would be a distraction from their primary focus.

Terms of Reference 3 - best practice in corporate governance mechanisms, including:

a) preselection and nomination of director candidates.

The outcomes of current nomination and election practices do not meet best practice in respect of achieving diversity; institutional investors are able to have more influence than retail investors but the jury is still out on whether this is in the interests of all shareholders. Best Practice Guidelines need to be reinforced to achieve appropriate diversity.

The AIMA (1997) Investment Managers Guide on Corporate Governance, under guideline 5, specifies the use of a Nomination Committee with a majority of independent directors and that in assessing candidates, requirements include 'the appropriate mix of skills, experience and *other qualities'*.

Research in Best Practice by McCabe (unpublished PhD, 2002) showed that some directors felt that value in the nomination process should be placed on the recruitment of 'variety and diversity' to bring new and different approaches to boardroom problems. Nevertheless, Patrick Durkin (AFR, 30/08/07, p.11) quotes research by Institutional Shareholder Services as showing that nearly half of all non-executive seats on top 100 public companies in Australia are held by just 123 individuals and that the chance of appointment, if not already a top 100 director, have actually fallen from seven in ten to three in ten in the last two years.

A more active approach by Nomination Committees to identifying a broader pool of talent is called for; a transparent mechanism for shareholders, including institutions, to nominate candidates may be considered at the individual corporate level. International research (Briggs 2007) has shown that, in the emerging hedge fund activism of recent years considerable action related to nominations for board seats (in a number of cases successful) of independents and/or hedge fund representatives. While the increased competition for director appointment which this entails may be useful in increasing

diversity there is a proviso in that hedge fund representatives may represent the particular interests of the funds rather than the interest of all shareholders, especially where there is divergence in time frames and taxation implications of decisions. This trend needs to be carefully watched.

b) advertising of elections and providing information concerning director candidates , including direct interaction with institutional shareholders.

As noted above, institutional investors do achieve interaction in respect of director candidates and election. We consider there is a case for making more information available to shareholders on director candidates and link this with the case for direct election.

The provision of objective information on director candidates, as well as opportunity for candidates to provide a statement, is discussed above in the context of the issue of direct election.

c) presentation of ballot papers.

This has been well dealt with by the Chartered Secretaries of Australia (2006). Their sample voting paper and rules form an excellent spring board for corporations to make this change.

d) voting arrangements(eg. direct, proxy).

We consider there is considerable merit to the proposal for the direct vote option and this is discussed in detail above; however the minimum change which is required is to ensure that all those holding proxies and not just the Chairman of the meeting, be required to vote these proxies as directed under all circumstances.

The present provisions in respect of proxy voting arrangements, especially where the proxy appointed is not the chairman of the meeting, have the potential to frustrate the intentions of the shareholder and may not be clearly understood by the retail shareholder. This would require amendment to the Corporations Act. McConvill and Bagaric (2004) provide a good discussion of this issue and the proposed change to the Act.

***e)* conduct of Annual General Meetings.**

No further comment.

Terms of Reference 4 - the effectiveness of existing mechanisms for communicating and getting feedback from shareholders.

There is evidence of increased activism in the 2006, and to a degree 2007, AGM seasons, which potentially has provided feedback to corporations. However, this engagement may not be long lasting unless there is evidence that at least some corporations are listening.

There is evidence that a greater proportion of voting rights on shares were exercised in 2006 relative to earlier years. It is possible that opening the option for shareholder

resolutions on remuneration played some part. Certainly remuneration has been the area of greatest dissent. Florence Chong (The Australian, 19/01/07 p17) quotes proxy voting advisor ISS data to support this. However, the data cannot distinguish institutional and retail investors. Nevertheless, questioning by institutional investors should also be able to represent the interests of retail investors on issues such as remuneration.

Our research in 2000 (Nowak and McCabe, 2006) showed that institutional investors were reluctant to enter open confrontation with corporations and, where dissatisfied and engaged, preferred to communicate directly with the board or executive. Active support of dissenting resolutions on remuneration would represent a change of approach. However, given the growing disquiet about remuneration this cannot be discounted. While there is this evidence of increased feedback from shareholders it is not yet clear that such feedback is having an impact. If it is seen by shareholders as not impacting then a return to shareholder apathy is the most likely outcome.

Terms of Reference 5 - the particular needs of shareholders who may have limited knowledge of corporate and financial matters.

No further comment.

Terms of Reference 6 - the need for any legislative or regulatory change.

As noted in relation to 3d) above the minimum Corporations Act change required is to ensure that all those holding proxies and not just the Chairman of the meeting, be required to vote these proxies as directed. Direct voting and changes to information provision by corporations in relation to resolutions to be voted do not appear to require legislative change but need to be strongly encouraged, for example by incorporation in best practice principles.

Discussion and support for this view is provided above in relation to the other 5 terms of reference.

References:

Australian Investment Managers' Association. 2007. *Corporate Governance: A Guide for Investment Managers and Corporations*, 2nd ed.

ASX 2006 Australian Shareowner Study. 2007. Australian Securities Exchange.

Briggs,T.W. 2007. Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis. *Journal of Corporation Law* 32 (4): 681-738.

Chartered Secretaries Australia, 2006. *Expressing the Voice of Shareholders; A move to direct voting. Discussion Paper.*

Chong, F. 2007. Investor activism increases, *The Australian*, 19 January.

Companies & Securities Advisory Committee, 2000. *Shareholder Participation in the Modern Listerd Public Company; Final Report*. ASIC.

Durkin, P. 2007. Companies urged to dig for board talent. *Australian Financial Review*, 30 August.

Hoyle, S. 2007. Voting Veritas…all those in favour please tick the box, *Sydney Morning Herald*, 3 March.

McCabe, M. 2002. Directors' Perceptions of Best Practice in Corporate Governance in Australia. PhD diss., Curtin University of Technology.

McConvill, J. and M. Bagaric. 2004. Ambiguities and Inconsistencies in Relation to the Obligations of Proxies under Corporations Law: A Model for Reform. *University of New England Law Journal* (4): 109-133.

Nowak, M. and M. McCabe, M. 2006. Institutional Investors: Do they have a role in the Monitoring of Corporate Performance? *Contemporary Issues in Business and Government* 12 (2): 1-14.

10 September 2007

The Journal of Contemporary Issues in Business and Government
2006 Volume 12, Number 2, pp 1-14

Institutional Investors: Do they have a Role in the Monitoring of Corporate Performance?

Margaret Nowak
Curtin University of Technology

Margaret McCabe
Curtin University of Technology

Abstract

In response to perceived anger of shareholders resulting from the combination of company failures, high termination payouts and CEO remuneration packages there has been growing media interest in assigning a role to institutional investors to participate as active monitors of corporate performance. This paper explores how institutional investors undertake the monitoring of corporate performance and governance processes and structures.

Selected funds managers were interviewed about their approach to active institutional monitoring of invested companies. This article reports on the processes which funds managers indicated they adopted to monitor company performance and governance. It looks at managers' perceptions of the considerations which influenced the development of attitudes and policies about monitoring and the decision to undertake active monitoring and influencing activity. The processes and procedures through which exercise of real influence within invested companies is perceived to flow are discussed. The funds management industry is not homogeneous in its approach to active institutional monitoring and relations with invested companies. Thus future research to measure the impact on corporate performance of the presence of institutional investors on the share register may need to differentiate between categories of institutional investor.

Introduction

The Australian financial media has in recent years been active in reporting perceived anger of shareholders on issues such as termination payouts and executive and director remuneration (for example, Boyd, 2005; Lee, 2005a). There has also been considerable political interest in extending regulation of shareholder rights to enhance shareholder participation (Priest, 2004a, 2004b).

Issues relating to governance and performance taken up by shareholders and reported in the Australian and international financial press have included: campaigns to install independent chairpersons or independent directors; campaigns against individual company's pay policies; and active support for, or opposition to, company amalgamations or takeovers (Boyle, 2004; Buckley, 2004; Borrusin, 2006). High profile campaigns, such as those in Australia focussed on AMP and National Australia Bank, generally catch the notice of the press. However, such campaigns affect a small proportion of listed companies directly. There has been growing media interest in assigning a role to institutional investors to participate as active monitors of corporate performance (Mackenzie, 2004; Stapledon & Paatsch, 2004; Buffini, 2005).

Recent research has suggested there is a positive relationship between institutional ownership and the outcomes of governance monitoring of management activities. Hsu and Koh (2005) have found that, in specified circumstances, institutional presence on the share register of Australian companies appears to be a proxy for governance mechanisms to mitigate aggressive corporate earnings management. Sharma (2004) has found that the likelihood of fraud decreases as the percentage of independent institutional ownership increases. These studies focus on the overall proportion of institutional investors' holdings in the firm. They do not consider the process through which these outcomes could have been delivered, nor whether institutional shareholders can be treated as a block or, alternatively, demonstrate a variety of responses to potential activism in relation to their share portfolios.

Some international studies have differentiated between types of institutional investor. Bethel, Liebeskind and Opler (1998) found that acquisition of share blocks by some types of 'blockholders' had a positive effect on performance. Chen, Harford and Li (2004) report that the presence of institutional investors influences the quality of acquisition decisions, although this is specifically related to large and primarily block shareholdings. Almazan, Hartzell and Starks (2005) find an association between managerial compensation policies and institutional ownership, related to a measure which is a proxy for the payoff or incentives for institutional activism.

In the research reported here, selected funds managers discussed their approach to active institutional monitoring of invested companies. This data provided an opportunity to consider the processes involved in monitoring corporate performance and managers' perceptions of the considerations which influenced the development of attitudes and policies towards monitoring of invested companies in the industry. The data also allowed consideration of the processes and procedures through which the exercise of real influence within the invested entities is perceived to flow. It identified and underscored the notion that the funds management industry is unlikely to be homogeneous in its approach to active institutional monitoring and relations with invested companies. We suggest that future research seeking to measure the impact on performance of institutional investors in the share registry may need to utilise criteria to differentiate between categories of institutional investors.

The paper is organised as follows. Discussion of agency theory is followed by a brief discussion on the Annual General Meeting (AGM) as the possible site for retail and

institutional shareholder monitoring activity. Literature on potential institutional monitoring strategies, including the practices of activist institutional investors, is then considered. Following that, the data from a qualitative study of the perceptions of selected Australian funds managers of the monitoring role and practices of funds managers is reported and implications for research on the impact of institutional investors on corporate performance is considered.

Agency Theory, Monitoring and 'Agency Costs'

Berle and Means (1932) identified the tension, for the modern corporation, between the interests of the dispersed owners and those of the corporate management. Jensen and Meckling (1976) proposed agency theory as an explanation for the development of governance structures and processes in the corporation designed to manage the outcomes of this tension. They suggested that, in this agency relationship, the owner (shareholder) engages the agent (management) '…to perform some service on their behalf which involves delegating some decision making authority…' (1976: 308). The cost of monitoring activity undertaken to ensure that the services performed by the manager are in the interests of the shareholders are an 'agency cost'. Jensen and Meckling (1976) argued that monitoring should be undertaken by the owner or their 'representative' (at owner's cost) up to the point at which the marginal cost of monitoring equates to the increment to wealth resulting from reducing the adverse activities of the manager (e.g. in the form of increased managerial perquisites/rents or risk-averse decision-making).

The mechanisms of corporate governance, focussed on the board of directors, provide one avenue for monitoring the services performed by corporate management. At this level, monitoring corporate management is the responsibility of the company directors appointed to the board. Ostensibly, the shareholders 'appoint' directors to the board at the AGM of shareholders and are therefore able to hold their directors accountable at the AGM for the performance of their monitoring role. The legal and stock exchange listing requirements for the provision of information to the market provide the other major avenue for shareowners and prospective owners to monitor and make judgments on performance.

The spate of questioning (see examples given) of corporate governance processes and structures has been accompanied by suggestions that shareholders, including institutional shareholders, should become more actively engaged in overseeing and evaluating their boards' monitoring processes and outcomes. This has focused on opportunities for, and participation by, shareholders at the AGM. This is reflected in recent media reports on active shareholders willing to use the AGM to question and seek to influence boards' monitoring activities and board composition. At the same time there has been questioning in the media (Lee, 2005b; Borrusin, 2006; Greenblat, 2006) about the value of the AGM as an information and performance monitoring forum.

The Annual General Meeting as Shareholder Forum

The Commonwealth of Australia's 2004 Corporate Law Economic Reform Program *Audit Reform and Corporate Disclosure Act* (CLERP 9) reflects, in a number of provisions, the

view that shareholders should be empowered to actively address issues of corporate performance at the AGM. In particular, the legislation addresses the right of shareholders to timely advice of meetings, appropriate meeting procedures and the opportunity for shareholders to vote on the remuneration report.

Use of the AGM to influence corporate governance and performance issues requires resources to build a case and a coalition and, except for the quixotic, requires that there be a return on the resources used. The action by two former directors of Walt Disney Co. of 'travelling the country' for three months to meet with shareholders and investors (Lazaroff, 2004) in an unsuccessful bid to oust the chairman and CEO provides some indication of the level of resources needed.

For retail investors, the impediments to activism are substantial. First there are information costs (Williamson, 1979). Retail investors find it difficult and prohibitively costly to access the comparative industry and market information to make judgments on relative firm performance and difficult to access the information (some privately held) to make judgments on the adequacy of governance structures and processes. Second, there are the costs of orchestrating an intervention which will be heard at the AGM.

In 2003, 5.7 million Australians owned shares directly (Australian Stock Exchange, 2003a), but only 20 percent directly held a portfolio of $100,000 or greater and shares listed on the Australian Stock exchange constituted only 20 percent of the total value of the investments held by these retail investors. It is, therefore, questionable whether active involvement in monitoring those shares by shareholders is a reasonable expectation. For the retail investor, 'rational' apathy in relation to the governance performance of individual corporations is often optimal (Davies & Stapledon, 1993). Exit from the corporation, via sale of the shares, remains their most effective option when dissatisfied with perceived investment return or potential return.

Institutional Investor Activism

In the year to June 2003 (Australian Stock Exchange, 2003b), institutional investors accounted for 78 percent by value of shares traded; retail investors accounted for only 18 percent by value. Southwood (2003), Gillan and Starks (2003) and Romano (2001) are among those who argue that activism by institutional investors may be an effective substitute for activism by the retail shareholder. Gillan and Starks (p. 17) conclude that institutional investors' presence should lead to more informative prices, increased liquidity and lower monitoring costs for all investors.

Southwood (2003) also argues that institutional investors may facilitate the coordination of wider shareholder activity designed to protect and enhance long-term shareholder value. Southwood defines what he terms 'shareholder engagement' as involving 'any attempt to pursue shareholder objectives by: "voice" without a change of control in the company" (p. 226). This includes discussions with management, shareholder resolutions and the use of publicity. He proposes that the growing concentration of institutional shareholdings will encourage them to utilise the specialised resources of their fund managers for effective monitoring and performance analysis. This aids the use of voice rather than exit by this specific group.

Davies and Stapledon (1993) consider the action of institutional investors a form of internal monitoring, being 'the exercise, or threat of the exercise, by shareholders of their powers under the corporate constitution to remove incumbent management with whom they are dissatisfied, or at the least change to secure a change in the direction of the company's business policy' (p.64). They categorise institutional investor action into two forms: general intervention seeking the adoption of policy, which applies to all companies or a subset of them (e.g., audit independence, issues of non-voting shares); and particular intervention, which is confined to the individual company.

Collective Activism – Governance Principles

The cost of general intervention can be spread through collective action. Besides spreading the cost, such action is frequently able to achieve implementation through established regulatory structures such as Stock Exchange Listing Requirements. The Australian examples of this collective action have been particularly strong. The Australian Investment Managers' Association (AIMA) developed the influential Corporate Governance: A Guide for Investment Managers and Corporations (the Blue Book: 1995, 1997). Its successor organisation, Investment and Financial Services Association (IFSA) has continued to exert strong professional pressure in relation to governance standards and listing requirements in Australia.

One of the major impediments to collective activism for institutional investors remains the 'free rider' problem, whereby potential costs may not be spread across all beneficiaries. The costs of developing a coalition of institutions could be significant. Institutional investors are expected to weigh the cost of an intervention strategy against the potential (but uncertain) benefits they expect. In the case of action on matters of governance principle, these benefits may appear to be intangible.

Activism at the Level of the Corporation

The exercising of collective voice at the corporate level by institutions faces some of the barriers that confront the retail investor in relation to access to privately held (corporate) information, complexity of information, costs in mobilising support (e.g., in a proxy fight) and legal issues in some jurisdictions. Such legal issues include regulations on insider trading, requirements for all shareholders to receive equal access to information and obstacles to collective action including competition policy.

In introducing its Guidelines, AIMA (1997) take the position that the interests of major institutional shareholders is compatible with the interests of other shareholders. The guidelines provide a blueprint for institutional investment activity.

They include the proposal that investment managers 'should vote on all material issues at all Australian company meetings where they have the voting authority and responsibility' (AIMA, 1997: 9). The guidelines also make a strong push for direct communication between institutional investors and both senior management and the board on issues of corporate performance and governance matters. The guidelines suggest that a commitment to continuing communication might include 'expert discourse,

agreements or understandings about the process governing the dialogue and commitment to play a constructive role' (AIMA, 1997: 16).

Particular intervention is more likely to be approached in a competitive vein and requires a commitment in terms of costs on the part of the institutional investor. Davies and Stapledon (1993) note that research by Black and Coffee in the United Kingdom found the overall pattern of direct institutional shareholder intervention can be characterised as 'frequent dialogue, occasional informal intervention when a firm is in trouble and very infrequent formal intervention' (p. 75). Southwood (2003) proposes that influence is best achieved through consensual relationships, which manage issues and seek to avoid escalation into conflict. This necessarily involves close relations between the organisations and a commitment to the long term 'relational investing'.

Evidence on the Practice of Institutional Activism: Australian Funds Managers

Research Objectives

This study reports the perceptions of funds managers from 17 organisations with funds management activities, selected from among Australian institutional investors. The data collection was undertaken in research commenced in 1999 which explored directors' perceptions of best practice corporate governance. The aim in the data collection from funds managers was to identify their perceptions of best practice corporate governance, the performance monitoring activities which their organisation would engage with and their perceptions of influence over the governance practices of invested companies. This paper looks specifically at performance monitoring policies and processes and at funds manager's perceptions of whether influence was being exerted over governance practices in invested companies.

Data Collection and Analysis

Executives from a total of 17 Australian funds management organisations were interviewed in a semi-structured interview process. Table 1 provides details of the distribution of organisations included in the study over the range of the value of funds under management and the type of organisation.

Data was originally sourced from public sources and provided to the interviewees prior to the interview for confirmation or adjustment if necessary. In some cases the Annual General Meeting was scheduled or had been held close to the interview date. Participants ensured that information available for the research was accurate.

The research adopted a qualitative research design operating in the constructivist paradigm. The data examined in this paper was collected as part of a larger study examining features of corporate governance in Australia. In demonstrating that corporate governance is not a socially stable phenomenon but rather a set of personal constructs overlaid by legal and regulatory institutions, it was appropriate to use a research approach that was placed in the constructivist paradigm (Schwandt, 2000) using an interpretavist epistomology (McCabe, 2002).

Table 1: Distribution of Funds Management Institutions Interviewed

Type of organisation	Number of institutions	Range of Volume of Funds under Management
Major bank funds management entities	4	$8.7 billion - $22.7 billion
Merchant banks	3	$ 5.6 billion - $ 40.0 billion
Large funds management organisation	1	$ 172 billion
Small funds management organisation	4	$4.76 billion - $9.8 billion
Funds management linked to other financial institutions (eg insurance)	5	$2.2 billion - $28.9 billion

Source: Original table - funds under management provided at interview relate to published data at the time of interview.

Theoretical sampling (Glaser, 1992) guided the selection of participating funds management organisations. Theoretical sampling was achieved during the course of a preliminary study. The research is descriptive and inductive (Merriam, 1988) Content analysis procedures consistent with the grounded theory research approach (Strauss & Corbin, 1990; Whiteley, 2000) were used to identify themes and concepts. The analytical process is an iterative one providing for repetitive interrogation of the data and the emergence of meaning. The NUD.IST™ (Richards, 1996) software package assisted the analytical process as a data management tool. Analysis occurred within the iterative interrogation of the data. The software package facilitated the questioning, classification and categorisation of interview data conducted by the researcher

Findings

In reporting the data the convention adopted for acknowledging extracts from interviews is to introduce and to conclude each quote with the following designation using a double slash (//). Respondents' words have been used where possible in the development of the categories following the coding process.

Collective Activism

Activism at the collective level on issues of principle is well supported in the industry. Many of those interviewed referred to past collective action on issues of principle through the auspices of AIMA and to membership by their own organisation of IFSA. The comments of one funds manager on the establishment of AIMA following the collapses of Quintex and Bond Corporation are indicative of the motivation for collective action by the industry:

//…we have been fighting these battles individually, perhaps it would be more effective if we formed a group to debate these ideas//…it (the Quintex collapse) was the start of institutions being a bit more consistent in what we thought about these sort of governance issues.//

This motivation relates to issues of principle on governance, but collective action on principle can be triggered by particular corporate collapses or a series of such collapses.

Most of those interviewed referred to AIMA and IFSA when general issues of governance were discussed. They subscribed to a continuing role for institutional investors to participate in this form of collective action on matters of governance principle:

//…AIMA and now IFSA have had their impact really in helping the institutions…and also to display to boards that institutional investors are important…// …we have an opportunity to participate in the debate…to discuss with other institutions…but they are probably the bigger hotter issues // … it means that IFSA then has an ongoing role to play and they will usually involve themselves … to express a view and be listened to'; and '… to the extent that they form a block and use it appropriately like AIMA/IFSA//

Consistent with the literature (Jenson & Meckling, 1976), funds managers saw the decision to take an activist role, even on principle at the collective level, in terms of cost/benefit analysis. One manager commented in relation to the recent decision by his organisation to join IFSA:

But at the end of the day, forty five thousand dollars is a lot of money. So it is just a cost that we are going to have to assess in the future…

Another commented: 'We take a fairly low cost approach where we look after clients interests by selling out if we don't like the corporate practices...'

Monitoring at the Level of the Corporation

From the interviews a dichotomy appears to exist between those funds management organisations which sought to influence companies in which they invested and those who did not. Those interviewees who indicated that their organisation sought influence also reported that this influence was exercised and could yield results. On the other hand, those who did not seek to do so considered that seeking to exercise influence was a costly option which was a distraction from their role as investment managers. They indicated that their institutions instead opted for what in the industry is termed the 'Wall Street Walk', meaning quitting their shares if they have concerns about the direction of a firm or its governance structures and processes. The dichotomy tended to be related to the aggregate volume of funds under management. but this was only one factor. Another factor related to individual strategy. Some smaller funds managers would also seek influence in cases where their stake in smaller companies was relatively high.

Funds managers clearly outlining the more involved position, used terminology which expressed the existence of a relationship with the invested companies:

//…And that is what is so important about forming that relationship. Right up front with companies when you invest in them so everyone understands one another.//…you develop a relationship with the management of the company and we are not trying to tell them how to run the business but…we are challenging them on their strategy…we are constantly feeding into the management of the company.//…Using your relationship and trying tactically to move what is best// …institutional investors are asked for their opinions…//… you want a good relationship with them so you are getting a good information flow…//

For some, however, any involvement was a distraction:

//…we know about financial markets more than we do about running businesses.// …my primary focus is to beat the index and not change a company's way of doing things. I mean that is not my role.//…It is not the role of an institution…//

Some interviewees, mostly from funds management organisations at the lower end of funds volume under management, argued that active intervention depended on factors such as the relative importance of the stock in their portfolio or the importance of their holding in the company's share register:

// …they are big parts of our portfolio…it is those companies which you need to form that association with the board//… "X" is an example of where we were reasonably active in supporting the removal of some directors…we will get involved where we see we can tangibly add value.// …its very difficult for us on our own to exert much influence….where we are talking of 50-150 ml. cap. we would think that we have a greater influence.//

Forming and Managing Relationships with Invested Corporations

Where the institutional investor anticipated 'forming a relationship', investment analysts were identified as being central in the monitoring process:

// It is the responsibility of our analysts to have an ongoing view about how the company is performing in terms of corporate governance…// We have analysts who have experience in the market so it (monitoring) is a process which is through directors and a chain of directorships…and through the experience of individual analysts…we keep tabs…//

Direct and regular informal contact with the companies was part of this process:

//We visit companies…we visit them regularly.// Informal discussions between the analyst and the company…// …our analyst would be speaking to a range of people…// We really do watch our companies and we go and see the management…//Sometimes the communication can just be by way of a phone call…//…meeting with the board and knowing the board members.//

Within this communication process, there were clear processes to formalise and escalate contact where concerns were felt:

//We prefer to communicate dissatisfaction with the company rather than fight them//…well we would move it to a more formal footing if things were continuing…//

//…head of our Australian Equities team may also become involved…follow that up with a letter to both the chairman and independent directors…// If there is sufficient justification we will go straight to the chairman of the board.//… correspondence exchanges where we set down what we think should be an approach to be taken//

Public Activism: Voting the Shares/Using the Media

While a minority of the funds managers interviewed indicated that their organisation had a policy of voting on all issues at the AGM, others indicated that they either voted issues that affected them or were even more haphazard than that, with voting dependent on other issues such as geographical proximity. This response is interesting in the light of moves in Sarbanes Oxley in the USA, to require institutional investors to vote their shares:

//Our policy is that we vote on all issues, all companies, all issues.//…any sort of resolutions… we actually have a policy in house here whereby …we must as a discipline address those issues.// We are happy to vote…when we think we have a view which is meaningful and can have some influence…// We only vote when our shareholder value is affected…// …typically you vote on Australian ones…//…so I'd rather see it done on an optional basis//

While a handful of contemporary high profile examples of governance and boardroom fights which had involved a number of institutional investors were discussed in the interviews, the fund managers were generally averse to joining battles which spilled over into the media:

//A lot of these things get fixed prior to going to public meetings and doing what the Australian Shareholders Association does, which is basically berate directors publicly.// We prefer to communicate dissatisfaction with the company rather than fight them.//

Cost of Activism and the Wall Street Walk

Funds managers saw the decision to take an activist role, even at the collective level, in terms of cost/benefit analysis. All funds managers interviewed noted that selling shares (the Wall Street Walk) rather than engaging with the company was an option regularly adopted:

//Wall Street Walk …is always an option…as an active fund manager we may decide it is all too hard.// …if we don't feel we can support the management we don't try to fight them we will just sell the shares and go.// The first port of call is to buy and sell, when they are not an option then others are looked at.//

Some saw exiting the shares as their best option in almost all cases:

//Exit the shares…I mean in terms of the way we operate that is precisely what would happen.// We choose to sell, right...// We sell our shares, exit the register. We take a fairly low cost approach … by selling out if we don't like the corporate practices.//…time is always short in business…you just sell the stock.//

Respondents approached the decision to sell explicitly in terms of costs including time cost and as '*the way we do things around here*'. However, often implicit was a cost/ benefit calculation which was made explicit for some:

We've got to do a cost/benefit analysis…we might just say lets not worry about it, lets just sell.// …for the larger institutions that can't get in and out of their shares quite so easily…its incumbent on them to be more active in defending their investment.//

Discussion

Pozen (1994) argues that 'Since…institutions are organised and paid as passive portfolio managers, they could not possibly become active in a large number of companies' (p. 147). A number of the interviewees concurred with this conclusion. Kahn and Winton (1998) model the alternative strategies open to institutional investors using the dichotomy to trade or to intervene. The optimal decision, Kahn and Winton argue, depends on the nature of the industry and product of the target firm, the potential for speculative gains, the cost of information and of intervention, the size of the shareholding and the reservation prices of retail shareholders. Analysis of the research confirms that a trade or intervene dichotomy is a reasonable description of the broad decision context for a group of these firms. Where this is the case, funds managers' discussion on the optimal decision does refer to costs such as information and intervention costs, the size of the shareholding and the potential financial benefits.

It was apparent from the interviews, however, that some institutional investors had a stronger commitment to what is termed 'relational investment', which is quite close to what Pozen (1994) terms 'block expansionists'. The strategy followed by this group of funds managers included the exertion of real influence on the composition of the board, and the oversight of or action to comment on corporate strategy. This form of behaviour is consistent with the 'dominant shareholder' of agency theory, or blockholding which is prevalent in Europe (Becht & Roell ,1999). There is considerable empirical support for the position that large blockholders can and do exert control over management (Gillan & Starks, 2003: 14); however, their interests are not always consistent with, and may be in conflict with, the interests of the remaining, and specifically the retail, shareholders (Becht & Roell, 1999; La Porta, Lopez-de-Silanes & Shleifer, 1999; Faccio & Lang, 2002). In this respect, the enhanced monitoring capability of such institutions potentially provides private returns to the costs involved to that institution(s), but does not necessarily enhance the information base for market monitoring as proposed by Gillan and Starks (2003).

This diversity among institutions, suggests the need for further research to consider the potential for impact in the Australian market setting. The differences in stated institutional investors' policy approach towards monitoring suggests that future quantitative research relating institutional investor ownership and measures of

performance (as a proxy for monitoring activity) should differentiate institutional investors. One proxy measure for the different policy approaches by institutions found in this study may be approximated by the volume of funds under management.

In contrast to the 'blockholder' approach noted above another set of funds managers viewed intervention as not consistent with their expertise and not part of their role. It is this group, along with those who pursue the optimal strategy in the Kahn and Winton (1998) sense, who have the potential to provide the 'more informative prices, increased liquidity and lower monitoring costs for all investors' envisaged by Gillan and Starks (2003: 17). It is from the trading decisions of this segment of the industry' utilising their ability to specialise in information and achieve economies of scale in the monitoring process, that greater market efficiency can be expected to result.

On the other hand interventions relating to corporate governance principles are most likely to occur through collective activity of the institutional investors working through industry groups such as the Investment and Financial Services Association. This form of action did have the support of many institutional investors, despite the potential free rider problem. Collective action at this principles level does also promise improved monitoring information and processes for all shareholders.

References

Almazan, A. Hartzell, J. and Starks, L. (2005) *Active Institutional Shareholders and Costs of Monitoring: Evidence from Executive Compensation*. Working paper, Texas University, Texas, TX.

Australian Investment Managers' Association (1997) *Corporate Governance: A Guide for Investment Managers and Corporations (2nd Ed)*. AIMA, Sydney.

Australian Stock Exchange (2003a) *2003 Australian Share Ownership Study. Australian Stock Exchange*. Retrieved: 24 August 2004 from www.asx.com.au/WhatsNew_HP2shtm#Share_Ownership_Study.

Australian Stock Exchange (2003b) *End of Financial Year Summary, Media Release 30 June 2003*. Retrieved: 24 August 2004 from www.asx.com.au.

Becht, M. and Roell, A. (1999) Blockholdings in Europe: An international comparison. *European Economic Review*, 43 (4-6) pp 1049-1056.

Berle, A. and Means, G. (1932) *The Modern Corporation and Private Property*. Macmillan, New York, NY.

Bethel, J., Liebeskind, J. and Opler, T. (1998) Block share purchases and corporate performance. *Journal of Finance*, 53 (2) pp 605-635.

Boyd, T., 2005, 'One in the eye for the directors' *Australian Financial Review*, October 26,p56.

Borrusin, A., 2006, 'Battle to put teeth in board elections' *Australian Financial Review,* February 28, p.12.

Boyle, M., 2004, 'When will they stop?' *Fortune*, 149 (9), p.123. May 3.

Buckley, N., 2004, 'Wella investors sue P&G over takeover' *Financial Times*, April 13, p.19.

Buffini, F., 2005, 'Super row puts fund managers on notice' *Australian Financial Review*, January 11, p1, p.35.

Chen, X., Harford, J. and Li, K. (2004) Institutional investors and corporate acquisition decisions. University of Washington Business School, Seattle. (Unpublished working paper)

Commonwealth of Australia (2004) *The Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (known as CLERP9).

Davies, P. and Stapledon, G. (1993) Corporate governance in the United Kingdom. In Isadsson, M. and Skog, R. (Eds) *Aspects of Corporate Governance: The Stockholm Symposium 1993, Corporate Governance Forum*. Jurisforlaget, Stockholm.

Faccio, M. and Lang, L. (2002) The ultimate ownership of Western European corporations. *Journal of Financial Economics*, 65 (3) pp 365-395.

Gillan, S. and Starks, L. (2003) Corporate governance, corporate ownership, and the role of institutional investors: A global perspective. *Journal of Applied Finance*, Fall/Winter pp 4-22.

Glaser, B. (1992) *Basics of Grounded Theory Analysis*. Sociology Press, Mill Valley, CA.

Greenblat, E. (2006) Teele's quiet revolution rocks the AGM. *Australian Financial Review*, 7 January, 12.

Hsu, G. and Koh, P. (2005) Does the presence of institutional investors influence accruals management? Evidence from Australia. *Corporate Governance*, 13 (6) pp 809-823.

Jensen, M. and Meckling, W. (1976) Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure. *Journal of Financial Economics*, 3 pp 305-360.

Kahn, C. and Winton, A. (1998) Ownership Structure, Speculation, and Shareholder Intervention. *The Journal of Finance*, 53 (1) pp 99-129

La Porta, R., Lopez-de-Silanes, F. and Shleifer, A. (1999) Corporate Ownership around the World. *Journal of Finance*, 54 (2) pp 471-517.

Lazaroff, L. (2004) Disney shareholders' Revolt Widens, with 33 Percent Voting to Oust CEO Eisner, *Knight-Ridder/Tribune Business News*, 4 March, 1.

Lee,T. (2005a) The devil in the pay detail. *Australian Financial Review*, 2 November , 15.

Lee, T. (2005b) An AGM without shareholders. *Australian Financial Review*, 1 December, 18.

Mackenzie, C. (2004) Don't stop rattling those boardroom chains. *Financial Times*, 10 May, 6.

McCabe, M. (2002) Directors' perceptions of best practice in corporate governance in Australia. PhD thesis. Curtin University of Technology, Perth.

Merriam, S. (1988) *Case Study Research in Education: A Qualitative Approach*. Jossey-Bass, San Francisco, CA.

Pozen, R. (1994) Institutional investors: The reluctant activists. *Harvard Business Review*. Jan/Feb pp 140-149.

Priest, M. (2004a) Committee pushes for new shareholder rights. *Australian Financial Review,* 5-6 June, 5.

Priest, M. (2004b) Clerp9 sequel in pre-production. *Australian Financial Review*, 28 June, 8.

Richards, T. (1996) *User Manual for NUDIST: A Text Analysis Program for the Social* Sciences (Version 3.05). QSR, Melbourne.

Romano, R. (2001) Less is more: Making institutional investor activism a valuable mechanism of corporate governance. *Yale Journal on Regulation*, 18 (2) pp 174-251

Schwandt, Thomas A. (2000) Three epistomological stances for qualitative inquiry. In Denzin, N. and Lincoln, Y (Eds) *Handbook of Qualitative Research*. Sage Publications, Thousand Oaks, CA. 189-214.

Sharma, V. (2004) Board of Director characteristics, institutional ownership and fraud: Evidence from Australia. *Auditing*, 23 (2) pp 105-117.

Southwood, P. (2003) Shareholder engagement: prospects for improving corporate social responsibility. *International Journal of Business Performance Management*, 5 (2/3) pp 223-236.

Stapledon, G. and Paatsch, D. (2004) Corporate Governance gone awry. *Australian Financial Review,* 27 October, 63.

Strauss, A. and Corbin, J. (1990) *Basics of Qualitative Research: Grounded Theory Procedures and Techniques*. Sage, London.

Williamson, O. (1979) Transaction-Cost Economics: The Governance of Contractual Relations. *Journal of Law and Economics*, 22 pp 233-261.

Whiteley, A. (2000) Grounded research: A modified grounded theory for the business setting. Curtin University of Technology, Perth. (Unpublished working paper)