ABN 39 031 495 845

Michael O'Sullivan
President

Phillip Spathis
Executive Officer

Level 28, 2 Lonsdale Street,
Melbourne, Vic, 3000
Tel: 03 9657 4375
Fax: 03 9657 4378
www.acsi.org.au

14 September 2007

Mr David Sullivan
Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
PO Box 6100
Parliament House
CANBERRA ACT 2600

By Email: corporations.joint@aph.gov.au

Dear Mr Sullivan

Inquiry into Shareholder Engagement and Participation

The Australian Council of Super Investors ("ACSI") is a not-for-profit member association established in 2001 which provides education, research and advocacy services on corporate governance issues. Our membership comprises 42 superannuation funds and associated bodies that manage over $250 billion in investments.

Given the significant proportion of superannuation fund investments in the Australian equity market, the long-term viability of publicly-listed companies has a direct bearing on the value of investments and, ultimately, retirement incomes.

As a society, we do not rely on "black letter" law alone to improve corporate behaviour, although legal mechanisms are critical to ensuring that community expectations are clearly spelled out. As long-term investors, ACSI members consider that the legal frameworks and mechanisms must support effective engagement between companies, shareholders and the wider community.

ACSI believes that there are already reasonable shareholder "empowerment" provisions that support constructive shareholder participation in Australia. We consider that the *Corporations Act* and the ASX Listing Rules provide a reasonable balance of technical and principles-based requirements on companies. In this regard, Australia's framework of corporate governance should be highly regarded when compared with other regimes across the globe.

However, there is always scope to improve the systems of governance oversight in ways that do not create more onerous requirements on companies and shareholders.

ACSI welcomes the Parliamentary Joint Committee on Corporations and Financial Services' inquiry into shareholder engagement and participation, and sets out below its comments on the issues raised in the terms of reference.

1. Barriers to the effective engagement of all shareholders in the governance of companies.

Supporting direct voting

Whilst we acknowledge that legislative change is not required in order to facilitate direct voting, ACSI would like to publicly support the Chartered Secretaries Australia's (CSA) position in relation to direct voting. The CSA is promoting the implementation of provisions in companies' constitutions that will enable shareholders to exercise their voting rights through direct voting, in addition to exercising their existing right to appoint a proxy holder.[1]

While direct voting is predominantly applicable to retail shareholders, ACSI supports any measures that improve access to and exercise of voting rights.

We are aware that the CSA will be making a separate submission to the Committee and suggest that the Committee revert to the CSA with any queries on this subject.

Electronic voting and "lost votes"

ACSI is a member of the Investments and Financial Services Association's (IFSA) Proxy Voting Roundtable and supports and endorses the comments made in IFSA's submission to this inquiry.

In particular, ACSI endorses IFSA's comments about the need for electronic proxy voting to enhance an "end to end" proxy voting system and IFSA's observations on the need for a clear audit trail to identify the number of votes received and the number of votes lodged.

Currently in Australia there is no requirement for independent verification of votes cast at a company meeting, nor is there a method of creating a meaningful audit trail. This is of particular concern to ACSI, especially given the issue of "lost votes" that was recently highlighted in research undertaken by AMP Capital, which identified that their voting instructions had been "lost" in over 4% of cases[2].

In addition to the recommendations made by IFSA, ACSI also notes the recent introduction of a power in section 342 of the United Kingdom's *Companies Act* 2006 for members to require an independent report on a poll.

The power is limited to:

(a) members representing not less than 5% of the total voting rights of all the members who have a right to vote on the matter to which the poll relates (excluding any voting rights attached to any shares in the company held as treasury shares), or

---

[1] See 'CSA's guide to implementing direct voting' <http://www.csaust.com/Content/NavigationMenu/NewsAdvocacy/Discussionpapers/Guide_implementing_direct_voting.pdf>, sighted 28 August 2007

[2] See AMP *Capital's Corporate Governance: mid-year update*, August 2006. A copy can be obtained at www.ampcapital.com.au

(b) not less than 100 members who have a right to vote on the matter to which the poll relates and hold shares in the company on which there has been paid up an average sum, per member, of not less than £100.

ACSI recommends that the Committee consider introducing similar provisions to the United Kingdom, along with a clarification of what would constitute "independent verification" of votes cast on a poll.

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

In ACSI's experience, the introduction of a non-binding shareholder vote on a company's remuneration report in the CLERP 9 reforms has been one of the single biggest catalysts for improved levels of engagement between institutional shareholders and company directors.

The remuneration report has provided a basis for companies to explain the rationale of a company's approach on pay, and the non-binding vote has given shareholders an opportunity to express their views.

In addition, the "if not, why not" requirements arising out of the ASX Corporate Governance Council's Corporate Governance Principles and Recommendations encourage companies to explain their approach to corporate governance and explain any divergences from generally accepted standards.

ACSI has found that, since the introduction of the non-binding vote on remuneration reports and the ASX Corporate Governance Council's Principles, more companies are proactively seeking out institutional investors (and their representative organisations such as ACSI) to discuss the company's approach to corporate governance.

However, there are some areas of reform that would further assist institutional shareholders to engage with companies.

Annual reports

We recommend that companies be required to include in their annual reports information about remuneration consultants to the company. In particular, the annual report should contain details about:

- The remuneration consultants who have been appointed,
- Who appointed them (i.e. the board or a committee of the board), and
- The types of services provided to the company.

This information is necessary to give shareholders the requisite level of comfort that there are no inherent conflicts of interest in the services being provided, and that no prior relationship exists between the remuneration consultant and a senior executive or director.

We note that the following companies already disclose this type of information voluntarily: BHP Billiton Limited, Iluka Resources Limited and Woodside Petroleum Limited.

Collective action by institutional shareholders

There are many benefits of institutional investors engaging collectively with companies about their corporate governance practices. A group of investors expressing similar concerns are more likely to be heard by the company, and the company can discuss the matter with a large number of shareholders more efficiently, rather than having repeatedly to explain its position.

This was clearly ACSI's experience when it held discussions with News Corporation in conjunction with other advisers and investors about News Corporation's proposed moved to Delaware in 2005.

However, there are certain sections of the *Corporations Act* (namely section 606 and Part 6C.1) which when combined with the very broad definitions of "relevant interest" and "associate" have a dampening effect on institutional investors acting collectively. Institutional investors could unintentionally breach these sections if they seek to act collectively, especially if they act outside the context of an upcoming company meeting. This issue is fully discussed by Professor Geof Stapleton in the chapter "Legal Limitations on Institutional Investors Participating in Corporate Governance Activities", in Paul Ali, Geof Stapledon and Martin Gold, *Corporate Governance and Investment Fiduciaries*, (LawBook Company) (2003). A copy of the relevant chapter of this book is attached to this submission.

The Australian Securities and Investments Commission recognised the difficulties posed by section 606 and Part 6C.1 for institutional investors, and released Policy Statement 128 and Class Order 98/649 (now updated as Class Order 00/455). If institutional investors comply with the Class Order, any agreement to act collectively and related discussions will be treated as not triggering section 606 or Part 6C.1.

However, as highlighted in the extract from *Corporate Governance and Investment Fiduciaries*, the Class Order is limited in its application, and is deficient in two key areas that may still cause difficulties for institutional investors who wish to act collectively.

In particular:

- The Class Order's application is restricted to a situation where institutions enter into an agreement about voting at a particular general meeting of shareholders. As Professor Stapledon notes, in Australia much of institutional investors' activity in relation to corporate governance issues occurs outside the context of company meetings, which means that the exemptions in Class Order 00/455 would have no application.
- The Class Order requires institutions to disclose to the company and to the ASX the fact that they have a voting agreement in relation to a company meeting and other specified details. As Professor Stapleton notes, this disclosure runs counter to the preference of institutional investors to hold "behind the scenes" discussions with companies wherever possible.

From a superannuation fund perspective, superannuation fund trustees would be unlikely to enter into a formal "voting agreement" (since a decision of a superannuation trustee on investment or governance matters requires a two-thirds approval of the trustee board). A superannuation fund is more likely to share and exchange information with other superannuation funds and fund managers, which could nevertheless potentially bring them within the operation of section 606 or Part 6C.1.

Whilst institutional investors could apply to ASIC for relief in a specific case, the process for obtaining relief can be drawn out and would most likely involve the public disclosure that is undesirable for the investors and companies.

ACSI urges the Committee to raise these issues with ASIC with a view to ASIC revising the terms of Class Order 00/455 to more closely reflect actual practice in the marketplace and to consider the options for reform outlined by Professor Stapledon in the "Possible Reform" subsection of the chapter cited above.

When addressing the Securities and Derivatives Industry Association conference in June 2007, Mr Jeremy Cooper, Deputy Chairman of ASIC, discussed whether "disaggregation" relief should be granted to investment funds because their aggregate group holdings in companies are close to the 20% takeover threshold. In the course of his address, he noted that "the problem created by investment funds approaching the 20% takeover threshold is expected to increase with increasing domestic 'investment' through superannuation and the likelihood that foreign investment funds will seek to increase their investment in Australian companies and schemes." Although his comments were directed to a different issue, ACSI notes that they are equally relevant to the problems raised by the operation of section 606 and Part 6C.1.

3. Best practice in corporate governance mechanisms, including:

(a) Pre-selection and nomination of candidates

ACSI supports the existing provisions in the *Corporations Act* that apply to the nomination and election of directors, and does not see any reason to alter the legislation in this area. We recognize that company constitutions outline the process for nominating directors to a board.

We also reaffirm the importance of existing provisions in the *Corporations Act* that allow shareholders to vote against the election or re-election of directors and the provisions that allow for the removal of directors. These provisions are an important "check" on directors where they are underperforming.

We note that there are no similar provisions in some other jurisdictions, including the United States. According to governance commentators and institutional shareholders in the United States, the inability for shareholders to exercise a binding "against" vote on the election of a director has been regarded as a major impediment to effective governance and shareholder scrutiny of the performance of directors and boards. Effectively, it creates an "entrenched" board.

(b) Advertising of elections and providing information concerning director candidates, including director interaction with institutional shareholders;

ACSI supports the existing laws about the advertising of company board elections. Generally speaking, companies do provide reasonable biographical information about candidates, including candidates who have not been endorsed by the Board.

ACSI members continue to support candidates who are prepared to bring a combination of experience, skill and strategic decision-making ability to the boardroom table. We recognise that most directors of publicly listed companies take their fiduciary duties seriously.

However, boards should look for skilled candidates who are not necessarily the "usual suspects" who can be considered for board positions.

According to research recently released by ACSI, more than 70% of new directors of ASX100 companies appointed during 2006 were already directors of ASX100 companies. In 2004, ACSI's research found that only 27% of new ASX100 company directors already were, or had been, a director of an ASX100 company.

As investors, we are interested in understanding how board candidates are selected, given the increasing prevalence of appointments from within the existing "pool" of directors.

ACSI recognises that Parliament cannot legislate for the deepening of the "gene pool" available for the selection and election of directors onto a Board. We recognise that this can be achieved through a combination of factors, including a genuine desire by company boards to find highly motivated and skilled directors who bring diverse life and work experience to the boardroom table. However, we draw this issue to the Committee's attention.

(c) Presentation of ballot papers

ACSI considers that there have been improvements in this area over recent years by companies. However, we encourage companies to use electronic means for circulating and filling out ballot papers.

(d) Voting arrangements (e.g. direct, proxy)

Electronic voting and "lost votes"

We reiterate our comments on electronic voting and "lost votes" made in section 1 of this submission.

Exclusion of associates' vote on the remuneration report

A central purpose of allowing shareholders a non-binding vote on remuneration reports is to give shareholders an opportunity to send a message to the company on the company's remuneration arrangements. In particular, shareholders are interested in the extent to which the remuneration arrangements align executives' interests with shareholders' interests and how they reward executives' performance.

At present, all shareholders (including directors and executives who are the beneficiaries of the remuneration arrangements) are able to participate in the non-binding shareholder vote. Since these directors and executives clearly have an interest in approving the remuneration arrangements, allowing them to vote may result in a higher "approval" vote on the remuneration report than might otherwise be the case.

To overcome this, ACSI recommends that the Committee consider an amendment to *Corporations Act*, to exclude "associates" from voting on a remuneration report. This would mean that the shareholder vote on the remuneration report would better reflect the true level of support for the remuneration arrangements amongst shareholders who are not affiliated with the company.

(e) Conduct of Annual General Meetings

We are aware that some questions have been raised about the effectiveness and relevance of annual general meetings. ACSI believe that annual general meetings are an important and effective mechanism for giving shareholders a voice about their investee companies.

However, we acknowledge that companies and shareholders could better use these meetings. We commend the practice of companies of inviting shareholders to submit questions with notice, and we also encourage companies to provide a web-cast of general meetings to improve shareholder access to meetings.

4. The effectiveness of existing mechanisms for communicating and getting feedback from shareholders.

As outlined earlier, ACSI's experience has been that engagement between shareholders and companies has improved in recent years, and ACSI believes that this has largely been due to the introduction of a non-binding vote on a company's remuneration report.

However, not all issues relate to remuneration. Other governance matters that are important to shareholders, such as board composition, constitutional amendments, mergers and takeovers are not covered by the remuneration reports, and there is scope to improve the feedback mechanisms for these other issues.

5. The particular needs of shareholders who may have limited knowledge of corporate and financial matters.

ACSI has no comment in relation to this sub-heading, as it considers this is principally relevant to retail shareholders, rather than institutional investors.

6. The need for any legislative or regulatory change.

In addition to the suggestions for reform outlined above, ACSI also notes the following areas for reform that could also be considered by the Committee.

All equity grants to executive directors should require shareholder consent

ACSI acknowledges the importance of a company paying its executives and directors proper and fair remuneration in order to attract, retain and motivate them. We also acknowledge that shares and share option schemes are an important long-term component of executive remuneration.[3]

ACSI considers that ASX Listing Rule 10.14 (which requires equity grants for directors to be subject to approval by shareholders) is an integral provision.

In October 2005, ASX Listing Rule 10.14 was amended to no longer require shareholders to approve an issue of shares as part of an executive director's remuneration package if the shares were bought on-market.

---

[3] In 2005, the average top 100 ASX/S&P CEO took home $4.56 m in remuneration, 23.64 % of which represented the long-term incentive component of this remuneration. Source: ISS Proxy Australia, *CEO Pay in the Top 100 Companies: 2004* (Research prepared for ACSI) (2006).

Investors have been concerned about the amendment to the Listing Rule. ACSI takes the view that prior approval by shareholders could reduce the potential for options being "back-dated" or "spring-loaded" (i.e. where option or share grants are timed to coincide with the release of positive information or share price slumps) because shareholders could assess vesting periods and performance hurdles.

Events in the United States have demonstrated that, if shareholders do not have the ability to approve equity grants, there is the potential for manipulation of equity grants by insiders, even in well-regulated and heavily scrutinized capital markets.

ACSI has submitted to the ASX that the current version of Listing Rule 10.14 should be revised to require shareholder approval of any acquisition of securities by a director outside of a genuine salary-sacrifice arrangement.

The ASX has agreed to review the Listing Rule.

Although the ASX is yet to make a decision, if the ASX does not amend Listing Rule 10.14, ACSI is concerned that some institutional investors may feel compelled to vote against an entire remuneration report where a company takes advantage of the Listing Rule provisions to avoid shareholder approval on equity grants. This would not be helpful, since as noted earlier in this submission, the introduction of a non-binding vote on remuneration reports has been a very helpful mechanism to encourage dialogue between investors and companies.

In summary, ACSI recommends that Listing Rule 10.14 be returned to its form prior to the October 2005 amendment. ACSI also recommends that the Committee monitor the ASX's review of the Listing Rule.

The Committee could also consider whether companies should be allowed to claim a tax deduction for the on-market purchase of shares for an incentive program *only if* awards to executive directors under that program have been approved by shareholders.

The Committee should also note that, in the context of the ASX Corporate Governance Council's considerations about equity-based remuneration to executives who are not directors, the Council intends to refer the matter to the ASX and Treasury to review the position of shareholder voting for equity-based remuneration plans within the existing framework of the Listing Rules and the Corporations Act.

Shareholder Privacy

Section 168 of the *Corporations Act* provides that a company or registered scheme must set up and maintain a register of members and section 169 sets out the information that must be kept on the register. Under section 173, **any person** is able to inspect the register. People who are not members of the company may be charged a fee for access to the register.

A recent amendment to the United Kingdom *Companies Act* introduced a "proper purpose" test for accessing the register, which in effect grants additional privacy to shareholders.[4] This is intended to protect members from being contacted for an improper purpose.[5]

[4] ss 116-119 of Part 8 of *Companies Act* 2006 UK. Further amendments are anticipated in terms of the content requirements of the annual return through amendments to regulations made under s857 of the Act.
[5] UK introduces a proper purpose test for accessing the register <http://www.csaust.com//AM/Template.cfm?Section=Home>, sighted 28 August 2007

The UK *Companies Act* does not define what is a “proper purpose”. Accordingly, the Institute of Chartered Secretaries and Administrators (ICSA) in the UK has recently issued guidance note on access to the register of members and the proper purpose test. ICSA has suggested examples of proper purposes might include:

- a member checking that his personal details have been accurately recorded on the register.
- a request from a regulatory or statutory body.
- an executor checking the shareholding of a deceased member.
- a member wanting to contact other members about matters relating to the company or their shareholding.

Examples of improper purposes might include:

- any purpose not related to the members in their capacity as members of the company (e.g.: commercial mailings).
- any communication to members that the company is concerned would threaten, intimidate or harass.
- performing credit or identity checks on individual members.
- any purpose that could be unlawful (e.g.: any purpose that might abuse someone’s rights under data protection legislation).

ACSI recommends that the Committee considers the UK legislation, but also suggests that the “proper purpose” should be defined if any similar Australian provisions were enacted. ACSI suggests that one “proper purpose” should be to allow shareholders access to information about other shareholders to enable them to contact other shareholders about issues relating to a general meeting resolution.

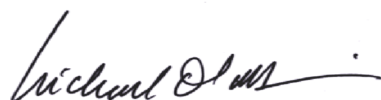
Parliamentary Joint Committee report on Corporate Social Responsibility

In June 2006, the Committee released its report: “Corporate responsibility: Managing risk and creating value”. Although the report contained a number of the recommendations that have already been implemented, ACSI believes that implementation of the following recommendation would enhance the effective engagement of shareholders in the governance of companies:

“*Recommendation 22:* that the Australian Government, in consultation with the investment community, develop educational material regarding the materiality of non-financial risks, for use by institutional investors and fund managers. Further information and research will assist all parts of the investment community to be better informed about important matters affecting company valuations, which will help effective engagement”.

Please contact Phillip Spathis on (03) 9657 4386 should you have any questions on the matters contained in this submission.

Yours sincerely



MICHAEL O’SULLIVAN
President

3

Legal Limitations on Institutional Investors Participating in Corporate Governance Activities

INTRODUCTION

Chapter 2 analysed this question: To what extent does the law require investment fiduciaries to play an active role in the governance of companies in which they invest? The present chapter also relates to institutional investors participating in the governance of companies in which they hold shares, but its focus is different. The present chapter assumes an investment fiduciary has decided to play an active role in the governance of companies in which it owns, or controls, shares. The issue examined is: What laws must the investment fiduciary be aware of as it devises its strategy for participating in corporate governance? The chapter is not intended to raise every statutory and common law provision that could apply in this type of situation, but rather to focus on some legal provisions which have been the subject of real concerns over recent years.

The structure of the chapter is as follows. Initially, to set the scene, there is an overview of the main ways in which institutional investors become involved in the governance of companies in which they hold shares. Then, the remainder of the chapter examines four legal issues that can potentially cause concern for an institutional investor which is considering taking an activist approach to corporate governance. These are, first, the extent to which trustees may validly delegate powers - particularly over voting rights - to fund managers. Second, there is a detailed analysis of the way in which the *Corporations Act* takeovers provisions and substantial shareholder provisions can inhibit collective action by institutional investors. Third, the potential application of the insider trading provisions is addressed. And fourth, there is

an introduction to the possibility that an institutional shareholder could fall within the "shadow director" concept in the *Corporations Act*.

There are several references in this chapter to interview studies involving Australian fund managers. The first set of interviews was conducted by Stapledon in Melbourne and Sydney in 1994. The interviewees were the senior executive or a senior fund manager of 13 Australian fund management firms, which managed listed Australian equities representing 17.3 per cent of the listed Australian equity market at 31 December 1993. The interviewees' firms included the five largest, and seven of the eight largest, managers of listed Australian equities at the end of 1993.[1] The second set of interviews was carried out by the University of Melbourne's Centre for Corporate Law and Securities Regulation during 1997-98.[2] It involved senior executives from 12 fund management firms. These 12 firms had, collectively, $151 billion in assets under management at that time, which represented 35% of the total funds under management of the 57 members of the fund managers' industry association.[3]

HOW DO INSTITUTIONAL INVESTORS GET INVOLVED IN CORPORATE GOVERNANCE?

Speaking broadly, those institutional investors that become involved in corporate governance tend to perform routine actions, extraordinary actions or both.

---

[1] See G P Stapledon, *Institutional Shareholders and Corporate Governance* (Oxford University Press, 1996), particularly Chs 6 to 8.

[2] The study is described in more detail in I M Ramsay, G P Stapledon and K Fong, "Corporate Governance: The Perspective of Australian Institutional Shareholders" (2000) 18 C&SLJ 110.

[3] At that time, the industry body was the Australian Investment Managers' Association (which later merged and became part of the Investment and Financial Services Association).

Routine actions undertaken by fund managers include:

- meeting regularly (perhaps once per year or every six months), on a one-to-one basis, with the chief executive and/or chief financial officer of investee companies;

- attending post-results presentations, "roadshows", brokers' lunches, and the like; and

- analysing companies' financial reports and information provided by securities analysts.

Extraordinary actions include:

- attempting to influence the outcome of proposed large transactions requiring shareholder consent, both at the "pre-marketing" stage[4] and at the general meeting (if the matter goes that far);

- attempting to persuade a company to adopt an accounting practice where the alternative is perceived to be placing downward pressure on the share price (eg booking "abnormal" restructuring costs in one hit rather than over a longer period);[5]

---

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

[5] See, eg, "Goodman Put Through the Mill on Costs", *Australian Financial Review*, 23 April 2001.

- objecting to grants of share options to executive directors which do not comply with best practice;[6] and

- intervening to change the composition of the under-performing (or otherwise unacceptable) board of an investee company. This phenomenon has been documented in Australia only since the early 1990s. Highly publicised instances occurred at Goodman Fielder Ltd[7] in 1994 and at Coles Myer Ltd[8] in 1995. Prior to those cases, there were institutional interventions at Darrell James Ltd[9] and Bennett & Fisher

---

[6] See, eg, "Wielding the Institutional Club", *Australian Financial Review*, 9 August 1993; "Not Everyone Happy at Coles", *Australian Financial Review*, 26 November 1993; "BT Says Exec Options Not GUD Enough", *Australian Financial Review*, 21 October 1998; "Directors' Days of Reckoning", *Australian Financial Review*, 26 October 1998; "Shareholders Demand a Say on Performance", *Australian Financial Review*, 6 November 2002. Best practice according to the Investment and Financial Services Association (IFSA) is set out in IFSA, *Executive Share and Option Schemes Guidelines* (IFSA Guidance Note No 12.00, 2000).

[7] See "Power Fight Certain to Change Face of Goodman", *Age*, 2 August 1994; "Board Won't Sit with Shears - Ultimatum from Goodman Fielder Directors", *Sydney Morning Herald*, 10 August 1994; "Goodman - The Final Showdown", *Australian Financial Review*, 17 August 1994; "Goodman Faces 2 Months' Uncertainty", *Australian Financial Review*, 22 August 1994; "Chanticleer: The Goodman War is Over - But Lasting Peace Needs Working On", *Australian Financial Review*, 8 September 1994.

[8] See "Scandal Rocks Coles Myer", *Australian Financial Review*, 5 September 1995; "Corporate Coup Begins", *Australian Financial Review*, 15 September 1995; "AMP Declares War on Coles", *Australian*, 12 October 1995; "Myer Family Dumps Lew", *Australian Financial Review*, 13 October 1995; "Institutions Unite Against Lew", *Australian Financial Review*, 18 October 1995; "Coles Myer: Over and Out", *Australian Financial Review*, 20 October 1995. Another corporate governance incident occurred at Coles Myer during 2002, which resulted in one of the non-executive directors failing in a bid to be re-elected to the board. Institutional investors certainly played a role, in the sense that several of them chose to disclose to the media their voting intentions in advance of the general meeting - and they were almost exclusively planning to vote against the director's re-election. However, unlike in 1995, the boardroom change in 2002 was not instigated by the institutions; it was the non-executive Chairman and several other directors who began the 2002 episode.

[9] See "Shareholder Revolt Rocks Darrell James", *Australian Financial Review*, 9 August 1991; "Photo Finish for Darrell James", *Australian Financial Review*, 9 September 1991; "Darrell James Coup Blocked", *Australian*, 14 September 1991; "Darrell James Board on Notice",

Ltd[10] in 1991, as well as institutional involvement in the resignation of the non-executive chairman and four non-executive directors of Westpac Banking Corporation in 1992.[11] The fact that some instances of very detailed monitoring have occurred in Australia in the past decade or so shows that the legal rules discussed in this chapter do not constitute an insurmountable barrier to institutional investor activism.

We now turn to some of the key regulatory issues that arise for consideration when one or more institutions takes an active interest in the governance of companies in which they hold shares.

ABILITY TO DELEGATE CORPORATE GOVERNANCE POWERS

Background

Where an investment fiduciary manages some of its clients' assets in a pooled fund - that is, a managed investment scheme like a unit trust or a pooled superannuation trust - the investment fiduciary has power to exercise the voting rights attached to equity investments of the pooled fund. The clients are unitholders in the pooled fund and cannot individually give voting directions to the investment fiduciary (the "responsible entity") managing the fund.[12]

The situation is completely different in the case of a "discrete client" - that is, a client whose assets are managed as a separate or discrete portfolio

---

Australian Financial Review, 16 September 1991.

[10] See "B&F Dissension Over Property Deal Vote". *Australian Financial Review*, 30 November 1990; "New Bennett Board Promises Stability", *Australian Financial Review*, 16 December 1991; "Former Bennett Chief Finally Heeds the Call", *Australian Financial Review*, 5 June 1992.

[11] See "Westpac: Neal and Four Directors Go", *Australian Financial Review*, 2 October 1992; "'Still a Long Way to Go' for Westpac", *Australian Financial Review*, 2 October 1992.

[12] This is the position under the *Corporations Act 2001* (Cth), Ch 5C, and the standard terms in scheme constitutions. See also H A J Ford, "Unit Trusts" (1960) 23 MLR 129, at 140-143.

(rather than collectively with those of other clients in a pooled fund). The voting rights attached to equity investments of a discrete client belong to that client unless it has validly authorised the fund manager to exercise the voting rights on its behalf. Often a discrete client will be the trustee of a large superannuation fund.

Until the early 1990s, the great majority of fund-management agreements were silent on the matter of voting.[13] Voting was, nevertheless, presumed to be a matter for the fund manager in most cases.[14] In late 1993, the Australian Investment Managers' Group (AIMG)[15] formulated a standard investment-management agreement which expressly delegated power to make voting decisions to the fund manager, subject to any specific direction from the trustee.[16] The Investment and Financial Services Association (IFSA), a successor to the AIMG, publishes the current version of this standard investment-management agreement - and it still delegates to the fund manager power to make voting decisions.

Over the years there has been some concern about whether superannuation fund trustees have the authority to confer on a fund manager the right to vote. This concern was highlighted in a paper prepared by Professor John Farrar for the AIMG in 1993.[17] The AIMG was sufficiently worried about the situation that it made submissions to the State Attorneys-General, seeking

---

[13] Finding of Stapledon's 1994 interview study.

[14] Ibid.

[15] The AIMG was later reconstituted as the Australian Investment Managers' Association (AIMA), which merged with two other bodies in 1998 to form the Investment and Financial Services Association.

[16] AIMG, *Standard Investment Management Agreement and Commentary* (AIMG, 1993), cl 12. Technically, what is delegated is power to give voting instructions to the custodian. This is because it is the custodian, as the registered (or legal) owner of the shares, to whom the proxy form and meeting materials are sent by the investee company.

[17] J H Farrar, *Legal Restraints on Institutional Investor Involvement in Corporate Governance* (unpublished paper presented at the AIMG and Business Council of Australia conference on "Corporate Governance and Australian Competitiveness: The Role of Institutional Investors", Sydney, 11 November 1993).

the introduction of wider delegatory powers into the State trustee statutes; and to the Insurance and Superannuation Commission (ISC), seeking an amendment to the *Superannuation Industry (Supervision) Act* 1993 (Cth) (SIS Act) or a new regulation under that Act, to clarify the matter.[18]

The voting right issue is really just one part of a wider issue: the capacity of superannuation fund trustees to leave the choice and making of investments to a fund manager. This wider issue is addressed before attention is turned to the sub-issue regarding voting.

Can trustees delegate the investment function?

It is helpful in the first instance to consider the wider issue independently of the SIS Act. Besides duties imposed by the SIS Act, there are three relevant factors:

(i) the general law duty of trustees to act personally;

(ii) the power of trustees to employ agents; and

(iii) powers contained in the trust deed.

Under the general law, trustees have a duty to act personally and not, in the absence of necessity, to delegate.[19] The general law and the State trustee statutes give trustees power to delegate only in very narrow

---

[18] See "Investors Seek Clear Proxy Law", *Australian Financial Review*, 24 January 1994; "Chanticleer: Directors Face More Pressure", *Australian Financial Review*, 11 February 1994. In 1998 the ISC was dissolved and its functions were split between the Australian Prudential Regulation Authority (APRA) and the Australian Securities and Investments Commission (ASIC), under the Wallis Committee reforms.

[19] *Turner v Corney* (1841) 5 Beav 515, at 517; *Spencer v Topham* (1856) 22 Beav 573; *Ex p Belchier* (1754) Amb 218.

circumstances, such as where trust property is situated out of the jurisdiction, or where a trustee is or will be absent from the State.[20]

The general law and the State trustee statutes also give trustees the power to appoint agents.[21] Finn notes that the relationship between the duty of trustees not to delegate and the power to appoint agents has never been analysed satisfactorily in private law.[22] Indeed, there has been an important difference of opinion amongst commentators and law reform bodies on this issue. Several of the State trustee statutes give trustees the power to employ agents "to transact any business or do any act required to be transacted or done in the execution of the trust or the administration of the [property of the trust]". One view is that, under provisions of this sort:

> "trustees, whenever they wish, can employ and pay an agent to do specified acts as instructed by them, but they cannot authorise the agent to decide for himself [or herself] what acts to do. Thus ... decisions on which investments to buy or sell cannot be delegated to an agent."[23]

A similar "narrow view" has been expressed by the English Law Reform Committee,[24] the English Law Commission,[25] the UK Pension Law Review

---

[20] See H A J Ford and W A Lee, *Principles of the Law of Trusts* (3rd ed, Law Book Company, 1996), [9620]-[9640].

[21] See *Speight v Gaunt* (1883) 22 Ch D 727; (1883) 9 App Cas 1; *Trustee Act* 1925 (NSW), s 53; *Trustee Act* 1958 (Vic), s 28; *Trusts Act* 1973 (Qld), s 54; *Trustees Act* 1962 (WA), s 53; cf the more limited power in *Trustees Act* 1936 (SA), ss 19 and 19a; *Trustee Act* 1898 (Tas), s 20.

[22] P D Finn, *Fiduciary Obligations* (Law Book Company, 1977), p 20.

[23] D J Hayton, "Developing the Law of Trusts for the Twenty-First Century" (1990) 106 LQR 87, at 88 (referring to the similarly worded section 23 of the *Trustee Act* 1925 (UK)).

[24] Law Committee, *The Powers and Duties of Trustees* (Law Com No 23, 1982), [4.16].

[25] Law Commission, *Trustees' Powers and Duties* (Consultation Paper 146, 26 June 1997), [3.3].

Committee,[26] the New Zealand Working Party on Trust Investment Powers,[27] and several commentators.[28]

Austin (now Justice Austin of the Equity Division of the Supreme Court of New South Wales) disagrees. He suspects that the narrow view is based

> "either on the notion that if the choice of investments is left to the fund manager, the trustees have gone beyond the employment of an agent and have purported to delegate; or on the notion that it is necessarily a breach of the trustee's duty of care for him [or her] to leave the choice of investments to the agent."[29]

Austin prefers a "broader view":

> "[T]hat there is no delegation unless the trustees have purported to abdicate their responsibility in favour of the delegate and [that] the use of professional managers to choose investments on behalf of the trust is an appropriate and responsible practice provided that the managers are competent and properly supervised."[30]

---

[26] Pension Law Review Committee (R Goode, Chair), *Report* (Cm 2342, 1993), [4.9].

[27] Working Party on Trust Investment Powers, *Trustee Investment - The Prudent Man Approach* (Government Printer, 1986); see A S Butler, "Modern Portfolio Theory and Investment Powers of Trustees: The New Zealand Experience" (1995) 7 Bond LR 119, at 146-147.

[28] See Butler, ibid at 134-135, 146; W A Lee, "Modern Portfolio Theory and the Investment of Pension Funds" in P D Finn (ed), *Equity and Commercial Relationships* (Law Book Company, 1987), p 304: "[A] trustee who authorises another to *make* and carry out investment decisions without prior consultation ordinarily breaches his [or her] duty to act personally." (Emphasis added.)

[29] R P Austin, "The Role and Responsibilities of Trustees in Pension Plan Trusts: Some Problems of Trusts Law" in T G Youdan (ed), *Equity, Fiduciaries and Trusts* (Carswell, 1989), p 124.

[30] Ibid.

This broader view has its supporters.[31]

The difference of opinion was probably not of great practical importance before the introduction of the SIS Act in 1993. Even if the narrow view were correct, it is likely that an appropriately drafted superannuation trust deed could, before 1993, have resolved any problem. Although "there is scant authority as to the extent to which the instrument constituting a trust can exempt a trustee from obligations which the law would otherwise impose",[32] it is probable that under the general law a trust deed can - subject to certain limitations - modify the duty to act personally.[33] It is strongly arguable that, before the enactment of the SIS Act, a

[31] See eg J R F Lehane, "Delegation of Trustees' Powers and Current Developments in Investment Funds Management" (1995) 7 Bond LR 36, at 42-45; Ontario Law Reform Commission, *Report on the Law of Trusts* (1984), Vol 1, p 46. Interestingly, Ford and Lee state initially that "[d]ecisions to vary the investment portfolio of the trust ... are ... decisions which cannot be committed to agents because of the wide variety of considerations which must be borne in mind before a variation in the investment portfolio should be undertaken": above n 20, [9540]. However, Ford and Lee (ibid) qualify their argument as follows: "This is not to say, however, that every decision to buy or sell property for a trust must be taken personally by the trustee, because purchases and sales of trust property can take place which do not affect the general character of the investment portfolio of the trust as a whole. Such purchases and sales may be made by agents, appointed by the trustee and acting under the trustee's general oversight." Cf G H Jones, "Delegation by Trustees: A Reappraisal" (1959) 22 MLR 381, at 393-395; *Re Vickery* [1931] 1 Ch 572, at 581.

[32] Lehane, ibid at 38.

[33] *Pilkington v IRC* [1964] AC 612, at 639; *Steel v Wellcome Custodian Trustees Ltd* [1988] 1 WLR 167, at 174: "In practice it is inevitable that the day to day investment decisions concerning a [trust] fund of this size [£3,200 million] would have to be delegated to advisers. ... [I]t is inconceivable that [the trustees] could apply their minds to every investment decision which has to be made"; *Jones v AMP Perpetual Trustee Co NZ Ltd* (unreported, 1993) (noted Ford and Lee, above n 20, [S9670]); Pension Law Review Committee, above n 26, para 4.9.25; Lehane, above n 31, at 39; Hayton, above n 23, at 88; R P Meagher and W M C Gummow, *Jacobs' Law of Trusts in Australia* (6th ed, Butterworths, 1997), [1723]. In several States, the limited statutory powers to appoint agents and to delegate are made subject to the provisions of the trust instrument: see Ford and Lee, above n 20, [12010].

superannuation trust instrument could validly have empowered the scheme's trustee to delegate discretions regarding investment of trust assets, provided that:

- the trustee retained responsibility for the acts of the delegate (fund manager); or
- much less likely, the delegate (fund manager) accepted the responsibilities of a trustee.[34]

Whether the appointment of an investment manager with power to choose investments amounts to a delegation of discretion assumed great importance on the introduction of the SIS Act. Under section 59 of the SIS Act, a provision of a superannuation trust deed is invalid if it permits a discretion, exercisable by a person other than the trustee, to be exercised without the consent of the trustee.[35] Therefore, if the narrow view were correct, a superannuation fund's trustee would have to vet each purchase or sale of a fund asset by a fund manager. It is clear, however, that the drafters of the SIS Act intended that trustees should be able to leave the choice of investments to a competent fund manager. Under the Act, the trustee must formulate and give effect to an appropriate investment strategy.[36] But the trustee is authorised to engage persons "to do acts or

[34] See Austin, above n 29, at 126; Lehane, above n 31, at 46-47; J J Quarrell, *The Law of Pension Fund Investment* (Butterworths, 1990), pp 26-27.

[35] There are limited exceptions: see *Superannuation Industry (Supervision) Act 1993* (Cth), s 59(1). Despite s 59, post-SIS Act superannuation trust deeds commonly contain a clause like the following (taken from an actual deed): "The Trustee may delegate to any one or more persons ... on such terms as the Trustee may think fit any of the authorities powers and discretions conferred upon the Trustee. Without limiting the generality of the foregoing the Trustee may appoint from time to time such one or more persons ... as the Trustee may think fit to act as ... investment manager ... subject to such conditions as the Trustee may from time to time determine and may delegate to and confer upon such an ... investment manager such authorities power or discretions, including the Trustee's power of delegation, as the Trustee may think fit."

[36] *Superannuation Industry (Supervision) Act 1993* (Cth), s 52(2)(f).

things" on its behalf.[37] Significantly, section 102 envisages the trustee hiring an investment manager to "control" fund money, "manage" investments, and report *afterwards* on the "making" of, and return on, those investments. The drafters of the SIS Act therefore appear to have adopted Austin's broader view.

The SIS Act would appear to have set up the following regime. The trustee must formulate an investment strategy. In so doing, the trustee is exercising a discretion. A fund manager may be appointed to choose and make investments in accordance with the trustee's investment strategy.[38] However, in choosing particular investments, the fund manager is merely implementing the trustee's strategy and not exercising any delegated discretion.[39]

Can trustees delegate voting power?

If the summary above is an accurate description of the regime established by the SIS Act, then one would expect that a superannuation trustee could confer on a fund manager not only the power to choose and make investments, but also the power to exercise voting rights attached to equity investments. After all, if the trustee can leave it to a fund manager to decide whether to sell or retain a parcel of shares, surely the trustee can give the fund manager power to make less drastic decisions like whether and how to exercise the votes attached to those shares? This view was shared by the ISC (when it was the regulator under the SIS Act):

---

[37] *Superannuation Industry (Supervision) Act 1993* (Cth), s 52(3).

[38] IFSA's *Standard Investment Management Agreement* does precisely this: cl 2.1, 3.1(a), 3.2(a).

[39] In contrast, the UK legislature seems to have assumed that a fund manager choosing investments *is* exercising a delegated discretion. Section 34(2) of the *Pensions Act* 1995 (UK) states: "Any discretion of the trustees of a [pension] trust scheme to make any decision about investments may be delegated by or on behalf of the trustees to a fund manager [authorised under the *Financial Services Act* 1986 (UK)] to be exercised in accordance with [a strategy formulated by the trustees]."

> "[T]rustees should be able, if they wish, to delegate the task of voting to the investment manager(s) retained by them. However, the terms of such a delegation should not purport to give this right exclusively to the investment manager on terms which could preclude the trustees from exercising voting rights. The terms of such delegation should ensure that trustees always retain the right to vote or to direct the investment manager how to vote on any question."[40]

IFSA has proceeded on the same basis. Clause 12.1 of its *Standard Investment Management Agreement* states:

> "The Trustee authorises the Manager to exercise any right to vote attached to a share or unit forming part of the Portfolio or to so direct the Custodian. The Manager must use its best endeavours to implement any direction the Trustee gives on the appointment of a proxy and the way in which the proxy should vote but in the absence of any direction may exercise or not exercise the right to vote as it sees fit, having regard to any general direction contained in [the investment instructions formulated by the Trustee in accordance with section 52(2)(f) of the SIS Act]."[41]

The process set out in IFSA's standard agreement - with the fund manager having power to give voting directions to the custodian - has been adopted widely.

Lehane, however, believes that the SIS Act does not permit a trustee to confer this much power on a fund manager. Lehane suggests that a trustee can allow an agent physically to cast a vote, but that "the decision as to

---

[40] Quoted in D Harding, "Do Institutional Investors in Australia Have a Fiduciary Responsibility to Vote?" (paper delivered at the AIMA and Institute of Corporate Managers, Secretaries and Administrators Proxy Voting Conference, Sydney, 7 September 1994).

[41] IFSA, *Standard Investment Management Agreement*, cl 12.1.

how votes are to be cast, particularly in a matter of any controversy, is likely to involve a discretion which the trustee must exercise itself".[42] If adopted by Australian courts, Lehane's approach would render the current commercial practice unlawful. Legislative reform along UK lines would then be required to allow the standard practice to continue. Section 34(2) of the *Pensions Act* 1995 (UK) states:

> "Any discretion of the trustees of a [pension] trust scheme to make any decision about investments may be delegated by or on behalf of the trustees to a fund manager [authorised under the *Financial Services Act* 1986 (UK)] to be exercised in accordance with [a strategy formulated by the trustees]."

TAKEOVER AND SUBSTANTIAL SHAREHOLDING PROVISIONS

Overview

Australia has a statutory system for regulating takeovers and, as Hill points out, the provisions "are more than capable of catching conduct not strictly associated with a takeover bid at all".[43] Part 6C.1 of the *Corporations Act* contains provisions which require any person who has a "substantial holding" (5 per cent or more) in a company to notify the company of the substantial shareholding and afterwards of certain changes to the holding. Section 606 of the *Corporations Act* prohibits a person from acquiring a relevant interest in a company's voting shares if, because of the transaction, that person's or someone else's voting power increases:

- from 20 per cent or below to more than 20 per cent; or

[42] Lehane, above n 31, at 49.

[43] J Hill, "Institutional Investors and Corporate Governance in Australia" in T Baums, R M Buxbaum and K J Hopt (eds), *Institutional Investors and Corporate Governance* (W de Gruyter, 1994), p 606.

- from a starting point that is above 20 per cent and below 90 per cent.

The concepts of "relevant interest" and "associate" are central to Part 6C.1 and section 606. The definitions of these terms are so broad that Part 6C.1 and section 606 could potentially be breached when several institutional investors act to some extent collectively in relation to a company in which each has a shareholding. A strong argument can be made that Part 6C.1 and section 606 should not apply in this type of situation. The relief that the Australian Securities and Investments Commission (ASIC) has provided (discussed below) is inappropriate, and it is desirable that the *Corporations Act* be amended to ensure that collective action by institutional shareholders on matters of corporate governance is not caught by Part 6C.1 or section 606.

The operation of Part 6C.1 and section 606 of the Corporations Act

Corporations Act, Part 6C.1

Part 6C.1 of the *Corporations Act*[44] contains a regime under which any person who obtains a "substantial holding", or whose substantial holding changes by a certain amount, or who ceases to have a substantial holding, must notify the company and the Australian Stock Exchange (ASX) of certain information about the holding, their identity and other matters. A person has a substantial holding if the total votes attached to voting shares in which they or their associates have relevant interests is 5 per cent or more of the total number of votes attached to the company's voting shares.[45]

A person who contravenes the notification provision in Part 6C.1 may be subject to civil or criminal sanction. A criminal breach can lead to a fine of up to $2,500 (or $12,500 if the person is a body corporate), or imprisonment for

---

[44] Part 6C.1 applies to all listed companies and to listed registered managed investment schemes: *Corporations Act 2001* (Cth), ss 671A and 671B.

[45] *Corporations Act 2001* (Cth), s 9 (definition of "substantial holder").

six months, or both.[46] Whether or not a person who contravenes the notification provision is convicted of an offence, they are liable to pay compensation to any person who suffers loss or damage because of the contravention.[47] This is not the case where it is proved that the contravention was due to the inadvertence or mistake of the wrongdoer, or to the wrongdoer not being aware of a relevant fact or occurrence.[48] However, in determining whether a defence on these grounds can be made out, the person's ignorance of or mistake concerning the law must be disregarded.[49]

A contravention of the notification provision in Part 6C.1 may have further consequences. First, various parties (including ASIC, the company concerned, a shareholder or former shareholder, and a person whose interests are affected) may apply to the court for an order under section 1325A. The court may make any orders it considers appropriate, including orders restraining the exercise of voting rights, directing the disposal of the shares, or vesting the shares in ASIC.[50] Second, the statutory injunction provision (section 1324) could be utilised. Under section 1324, ASIC or any person whose interests are, have been, or would be affected by a breach of the *Corporations Act* has standing to apply to the court for an injunction or damages. The particular importance of this for institutional investors is detailed later.

Corporations Act, section 606

Section 606(1) prohibits a person acquiring a relevant interest in a company's voting shares,[51] through a transaction in relation to securities entered into by

---

[46] *Corporations Act 2001* (Cth), ss 1311 and 1312; sch 3 (and s [ ]: definition of "penalty unit").

Corporations Act 2001 (Cth), s 671C(1).

[48] *Corporations Act 2001* (Cth), s 671C(2).

Corporations Act 2001 (Cth), s 671C(2).

[50] *Corporations Act 2001* (Cth), ss 9 (definition of "remedial order") and 1325A.

[51] The takeovers provisions in Chapter 6 of the *Corporations Act 2001* (Cth) apply to all listed companies, to any unlisted company with more than 50 members, and to listed registered managed investment schemes: ss 604 and 606(1).

or on behalf of the person, if, because of the transaction, that person's or someone else's "voting power" increases:

- from 20 per cent or below to more than 20 per cent; or
- from a starting point that is above 20 per cent and below 90 per cent.[52]

Section 610 defines a person's "voting power" as:

$$\frac{\text{Person's and associates' votes}}{\text{Total votes in the company}} \times 100$$

The "person's and associates' votes" is the total number of votes attached to all the voting shares in which the person or any of their associates has a relevant interest.

Any person who breaches the prohibition in section 606 is guilty of a criminal offence, and is subject to a fine of up to $2,500 (or $12,500 if the person is a body corporate), or imprisonment for six months, or both.[53] A person prosecuted under s 606 has a defence if it is proved that the contravention was due to inadvertence or mistake or to the person not being aware of a relevant fact or occurrence.[54] However, in determining whether a defence on these grounds can be made out, the person's ignorance of or mistake concerning the law must be disregarded.[55]

A transaction is not invalid merely because it involves a contravention of section 606.[56] Nevertheless, a breach of section 606 - like a breach of Part

---

[52] *Corporations Act 2001* (Cth), s 611 sets out numerous exceptions to this prohibition: eg for acquisitions under formal takeover bids, and for creeping acquisitions.

[53] *Corporations Act 2001* (Cth), ss 1311 and 1312; sch 3 (and s [ ]: definition of "penalty unit").

[54] *Corporations Act 2001* (Cth), s 606(5).

[55] *Corporations Act 2001* (Cth), s 606(5).

[56] *Corporations Act 2001* (Cth), s 607.

6C.1 - means various parties (including ASIC, the company concerned, a shareholder or former shareholder, and a person whose interests are affected) have standing to apply to the court for an order under section 1325A. The court may make any orders it considers appropriate, including orders restraining the exercise of voting rights, directing the disposal of the shares, or vesting the shares in ASIC.[57] Also of relevance where there has been a breach of section 606 is the statutory injunction provision (section 1324), outlined earlier.

The concepts of "relevant interest" and "associate"

Two crucial concepts in Part 6C.1 and section 606 are "relevant interest" and "associate". The shares which must be taken into consideration in each case include both (i) the shares in which the person in question has a "relevant interest", and (ii) any shares in which an "associate" has a relevant interest.[58]

Someone has a relevant interest in a company's shares if:

- they are on the company's register of members as the holder of those shares;
- they have power or control over the voting rights attached to the shares; or
- they have power to sell the shares or they control the power to sell the shares.[59]

An associate includes a person *in concert* with whom the primary person is acting or proposes to act; and a person with whom the primary person has, or

[57] *Corporations Act 2001* (Cth), ss 9 (definition of "remedial order") and 1325A.

[58] *Corporations Act 2001* (Cth), ss 9 (definition of "substantial holding") and 610 (defining "person's voting power").

[59] *Corporations Act 2001* (Cth), s 608(1).

proposes to enter into, an *agreement, arrangement, or understanding* (formal or informal, written or oral, legally enforceable or otherwise) for the purpose of controlling or influencing the composition of the company's board or the conduct of the company's affairs.[60]

Applicability of Part 6C.1 and section 606 to institutional investors

As shown above, "relevant interest" and "associate" are key concepts in Part 6C.1 and section 606. In the following two subsections, the concepts of relevant interest and associate are examined in the context of institutional shareholders. Following that, there is a description of how Part 6C.1 and section 606 could be contravened as a result of collective action by institutional investors.

(i) Institutional investors and the "relevant interest" concept

It is clear that virtually all Australian institutional investors (whether they be insurance companies, in-house managers of superannuation funds, or fund management firms which manage the assets of external clients such as superannuation funds and charities) would have a relevant interest in the Australian equity investments in their portfolios. This is because, as stated above, the definition of relevant interest includes not only power to vote in respect of a share, but also power to dispose of a share. Australian insurance companies have always had both of these powers over the equities in their statutory funds. Almost all fund management firms which manage external funds would always have had the power to dispose of equity investments. In the past, a number of fund managers did not have voting power over equity investments. However, by 1994, most Australian fund managers had the power to vote as well as to dispose of their clients' equity investments.[61]

---

[60] *Corporations Act 2001* (Cth), s 12.

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

(ii) Institutional investors and the "associate" concept

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

For example, if the managing director of Z Ltd was performing in a grossly unsatisfactory manner, to the serious detriment of Z Ltd's profitability, and if there were no effective non-executive directors on Z Ltd's board, then A, B, C, and D might legitimately and independently decide that this was an appropriate case for requesting that the board call a general meeting,[62] at which a motion would be proposed that the managing director be removed under the power in section 203D of the *Corporations Act*. Dialogue of any sort between A, B, C, and D in regard to this proposed course of action could easily result in their becoming associates. They may well be construed as acting "in concert" with one another (within the meaning of section 12(2)(c)),[63] and they may well be construed as having an "agreement, arrangement or understanding ... for the purpose of controlling or influencing the composition of [Z Ltd's] board (within the meaning of section 12(2)(b)). Either finding would constitute them associates.[64]

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

---

[62] See *Corporations Act 2001* (Cth), s 249D.

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

[64] If A and B were to make a voting agreement as to how their shares in Z Ltd were to be voted, each would have "power ... to control the exercise of [the other's] right to vote" (s 608(1)(c)), and each would have a relevant interest in respect of the other's shares: *TVW Enterprises Ltd v Queensland Press Ltd (No 2)* (1983) 7 ACLR 821.

independently, to vote against a motion to grant options to an executive director, which is on the agenda for the forthcoming annual general meeting of Z Ltd.[65] Communication or other interaction between A, B, C, and D in regard to this agenda item might well result in them being deemed to be associates. Again, they may be construed as acting in concert with one another. And they may be construed as having an "agreement, arrangement or understanding ... for the purpose of controlling or influencing the conduct of affairs of [Z Ltd]".

(iii) Institutional investors and Part 6C.1

If, in either of the examples given above, A and B each have a relevant interest in 1 per cent of Z Ltd's voting shares, and C and D each have a relevant interest in 2 per cent of Z Ltd's voting shares, then, as soon as they become associates through their dialogue as described above, they would each be obliged under section 671B (in Part 6C.1) to give a substantial holding notice to Z Ltd (and a copy to the ASX) within two business days after becoming aware of the information about the substantial holding.[66] Then, each would have to notify Z Ltd and the ASX (within two business days) if there was a movement of at least 1 per cent in their substantial holding, or if their holding dropped below 5 per cent.

(iv) Institutional investors and section 606

If, in either of the two examples given earlier, A has a relevant interest in 4 per cent, B has a relevant interest in 5 per cent, C has a relevant interest in 6 per cent, and D has a relevant interest in 6 per cent of Z Ltd's voting shares (totalling 21 per cent between them), then, as soon as they become associates through their dialogue as described above, section 606 would prohibit them from acquiring any more shares in Z Ltd.[67] Indeed, on a broad interpretation

---

[65] A similar situation has arisen occasionally in Australia: see above n 6.

[66] *Corporations Act 2001* (Cth), s 671B(6).

[67] As an old edition of the leading Australian corporate law text said: "It is worth emphasizing

of section 606, the dialogue itself could amount to a "transaction" prohibited by the section - so that there would be a breach even without a further purchase of shares.[68]

Section 606 is, however, for two reasons, less likely to be breached than Part 6C.1. First, the threshold for Part 6C.1 is 5 per cent of the voting rights whereas the threshold for section 606 is 20 per cent of the voting rights. Nevertheless, with the rapidly growing size of funds under management of Australian institutional investors, and the resultant increase in *concentration* of institutional shareholdings, it is now not uncommon for a handful of the largest institutional shareholders in any given company to represent more than 20 per cent of the equity capital. The second reason why section 606 is likely to be less of a concern to institutions than Part 6C.1 is that section 606 has - at least on one interpretation - the extra requirement that there must be a further acquisition of shares.[69] Nevertheless, in the case of most large Australian institutions, the total shareholding in a particular company consists of many - possibly dozens of - separate holdings for particular funds and/or clients. The acquisition element of section 606 could therefore be satisfied almost unintentionally - for example, by a purchase of shares for a unit trust which tracks an ASX index of which the particular company is a constituent.

---

that the legislation applies to all acquisitions of shares which fall within the basic prohibition, whatever be the motive of the acquirer and in particular, whether or not the acquirer intends to make a take-over bid": H A J Ford and R P Austin, *Ford's Principles of Corporations Law* (6th ed, Butterworths, 1992), p 707.

[68] H A J Ford, R P Austin and I M Ramsay, *Ford's Principles of Corporations Law* (10th ed, Butterworths, 2001), [23.250].

[69] This interpretation rests on the requirement in section 606 that a relevant interest must have been "acquire[d] ... through a transaction in relation to securities". But cf Ford, Austin and Ramsay, ibid, [23.250]: "the [institutional investors'] discussions themselves could be regarded as a transaction prohibited by s 606".

Practical relevance for institutions of breaching Part 6C.1 or section 606

It might be argued that the foregoing is largely academic, and that in practice there is little likelihood of institutions ever suffering any consequences as a result of a "technical" breach of Part 6C.1 and section 606. Any such argument would, for two reasons, be misconceived. First, several interviewees in Stapledon's 1994 interview project said that the potential application of these provisions served as a significant deterrent to their engaging in collective action at an investee company. Second, the overseas experience suggests that there is cause for concern. In the United States, where there are provisions similar to those in Part 6C.1 of the *Corporations Act*, lawyers who advise corporate managements provided the following advice in a public forum:

> [I]f several institutional investors communicate with each other with respect to an election of registrant directors or an alternative slate of nominees, registrants should consider asserting the application of Schedule 13D [ie the equivalent of Part 6C.1 of the *Corporations Act*].[70]

It is reasonable to expect that equivalent advice might be given by advisers to an Australian corporate management or board which was the subject of some form of exercise of shareholder democracy by more than one institutional investor. A significant weapon in this context could be the statutory injunction provision (section 1324 of the *Corporations Act*), outlined above. If the targeted directors had control of the board, they could bring an application under section 1324 in the name of the company,[71] alleging a breach of Part 6C.1, section 606 or both (depending on the circumstances). Whether or not any remedy was justified, the very prospect of the expensive litigation which this scenario entails would possibly be sufficient to deter institutions from exercising their shareholder rights in the first place. There

[70] Cited in B S Black, "Next Steps in Proxy Reform" (1992) 18 J Corp Law 1, at 51-2.

[71] There can be little doubt that the company would be "a person whose interests have been ... affected" by the contravention, as required for standing under section 1324.

is, in addition, the deterrent effect of the potential for criminal prosecution, as described earlier. All of this may have significant implications for Australia's system of corporate governance, as discussed below.

Why the law should not apply in this way

In the United States, the United Kingdom, Canada, and Australia (among other places), over the past few years, a consensus has developed that a properly functioning system of corporate governance requires the exercise, where appropriate, of shareholder rights by institutional investors.[72] This has been recognised recently by the Chairman of ASIC, when he stated in a widely cited speech that "[now] is a time for ... examining ways to motivate and empower shareholders - including institutions and fund managers - to accept greater responsibility for enforcing corporate accountability".[73] In the same vein, a prominent Australian company director stated several years ago that shareholders were the key to prevention of a recurrence of the corporate collapses of the late 1980s.[74] The first industry body dedicated to representing the interests of fund managers as institutional shareholders - the AIMG[75] - itself grew out of the dissatisfaction felt by several major Australian institutional investors with the "Wall Street walk" approach adopted by many Australian institutions in the 1980s.[76]

---

[72] See, eg, BS Black, "Agents Watching Agents: The Promise of Institutional Investor Voice" (1992) 39 UCLA L Rev 811; P L Davies, "Institutional Investors in the United Kingdom" in D D Prentice and P R J Holland (eds), *Current Issues in Corporate Governance* (Oxford University Press, 1993), p 92; B S Black and J C Coffee, "Hail Britannia? Institutional Investor Behavior Under Limited Regulation" (1994) 92 Mich L Rev 1997; Stapledon, above n 1; compare, however, H M Morgan, "Dealing with Institutional Shareholders: A Corporate Perspective" (unpublished paper presented at the Australian Investment Managers' Group/ Business Council of Australia conference on "Corporate Governance and Australian Competitiveness: The Role of Institutional Investors", Sydney, 11 November 1993).

[73] D Knott, "Corporate Governance - Principles, Promotion and Practice" (Monash Governance Research Unit Inaugural Lecture, 16 July 2002).

[74] See "Shareholders 'Key to Corporate Stability'", *Australian Financial Review*, 9 March 1994.

[75] See above n 15.

[76] See Hewett, above n 6.

Some reforms to the *Corporations Act* over the past decade reflect legislative recognition of this growing role for shareholders. For instance, the provisions regulating related party transactions give to shareholders the responsibility of deciding whether or not to allow certain transactions between public companies and related parties like directors.[77] A former Chairman of the Australian Securities Commission (as it was then called) said that "the related party transactions rules ... depend for their efficacy on investors paying attention to the affairs of the corporations in which they invest".[78]

The potential for collective action by institutions to contravene Part 6C.1 and/or section 606 of the *Corporations Act* does not sit comfortably with a model of corporate governance in which monitoring by institutional shareholders plays an important role. Despite recent increases in shareholding concentration levels in listed Australian companies[79] (due largely to growth in institutional share ownership), action by institutional shareholders would still normally need to be "collective", to some extent, in order to be effective - that is, in order to amass sufficient votes for a successful outcome. There is, therefore, an inherent incompatibility between, on the one hand, widespread exhortation of institutional investors to make better use of the rights attached to their shareholdings, and, on the other hand, a statutory regime which positively *discourages* any form of collective action in this regard.

ASIC's Class Order

In the light of concerns about the inappropriateness of takeovers law having a chilling effect on institutions' involvement in corporate governance, the Australian Securities Commission published Class Order 98/649 in 1998. If two

[77] See *Corporations Act 2001* (Cth), Ch 2E.

[78] "Shareholders Urged to be Vigilant by ASC's Chief", *Australian Financial Review*, 23 March 1994.

[79] See I M Ramsay and M Blair, "Ownership Concentration, Institutional Investment and Corporate Governance: An Empirical Investigation of 100 Australian Companies" (1993) 17 MULR 153, at 165-71.

or more institutions wish to act collectively, then provided they comply with the Class Order's requirements, their agreement to act collectively and any related discussions are treated as not triggering Part 6C.1 or section 606.[80]

Unfortunately, the Class Order is deficient in at least two key respects. First, its application is restricted to a situation where institutions enter into an agreement about voting at a particular general meeting of shareholders. But in Australia (as in the United Kingdom) much of what institutional investors do in the governance area occurs outside the context of companies' general meetings.[81] For example, what if three or four institutions wish to approach an underperforming company's independent non-executive Chairman to urge that the board consider replacing the CEO. This occurs nine months before the next annual general meeting, and without any likelihood of an extraordinary general meeting being held. Here, there is no scope for Class Order 98/649 to apply, but the intervening institutions may well become associates - and therefore face trouble under Part 6C.1 or section 606 - on the basis that they had an "agreement, arrangement or understanding ... for the purpose of ... influencing the composition of [the company's] board".[82]

Second, the Class Order appears to have been designed without reference to how institutional investors go about their corporate governance activities in Australia, much of the time. Namely, behind the scenes and away from the public spotlight wherever possible.[83] But in order to obtain the benefit of the Class Order, institutions are required to disclose to ASIC (and hence the market):

---

[80] ASIC, Class Order 98/649: Collective Action by Institutional Investors. See also the Policy Statement which explains the policy behind the Class Order: ASIC, PS 128.

[81] Eureka Strategic Research, *Shareholder Activism Among Fund Managers: Policy and Practice* (Report produced for the Investment and Financial Services Association, 2001); Stapledon, above n 1, at 117-131.

[82] *Corporations Act 2001* (Cth), s 12(2)(b).

[83] Eureka Strategic Research, above n 81; Stapledon, above n 1.

- the fact that they have made a voting agreement in relation to a general meeting of a named company;
- the names of all the institutions that are parties to the agreement;
- a summary of the matter to be voted on;
- a summary of "the objective of the action" and how the institutions propose to vote; and
- the relevant interests in the company held by each institution and the group of them collectively.

This not only runs counter to the preferred "behind the scenes" approach of most institutional shareholders, it also entails disclosing information which may be extremely sensitive. The final item requires disclosure of the size of each institution's shareholding. Under the *Corporations Act*, the disclosure threshold is 5 per cent,[84] and many fund managers jealously guard information about the size of their holdings that are below 5 per cent. If they wish to gain the benefit of Class Order 98/649, however, they would be required to tell the market - including all their competitors - how many shares they hold in the company concerned.

It is not surprising then that (i) fund managers interviewed in 1998 were largely sceptical about the merits of the Class Order,[85] and (ii) in the five years since its introduction, the Class Order does not appear ever to have been utilised.

---

[84] *Corporations Act 2001* (Cth), Part 6C.1.

[85] One interviewee said: "It is very cumbersome. You are required to declare exactly what your conversation was about. It's ridiculous that shareholders can't talk to one another." Another said: "The ASC Issues Paper missed the issues. It said they would grant relief but you had to nominate whom you were seeing and ask for a special arrangement, whereas all we want is the ability to speak to each other.": Ramsay, Stapledon and Fong, above n 2 at 127.

If the Class Order could not assist (eg because the institutional investor action did not relate to a general meeting), the institutions could apply to ASIC for a case-specific waiver or modification of Part 6C.1 or section 606 or both.[86] However, the process of applying to ASIC for a case-specific exemption or modification - particularly where the circumstances are out of the ordinary - can be drawn out and usually requires the involvement of external legal advisers. Also, the details of the exemption or modification must be disclosed by ASIC to the market.[87] Therefore, this path is likely to be as unattractive for institutions as Class Order 98/649 appears to be.

Possible Reform

Given the inappropriate impact of section 606 and Part 6C.1 described earlier, and the shortcomings in ASIC Class Order 98/649, this subsection makes a case for, and outlines a possible, reform of the *Corporations Act* to limit the width of the "associate" concept.

It is possible to distinguish between two broad classes of institutional shareholder actions - those concerned with, and those not concerned with, corporate control. The first example of an institutional intervention, given earlier, is an example of action by institutional shareholders which involves alteration (or potential alteration) to corporate control.[88] However, many matters on which institutions act collectively have nothing to do with

---

[86] ASIC's power to grant exemptions and make modifications in relation to section 606 and other takeovers provisions is contained in section 655A. Its power to do so in relation to Part 6C.1 is contained in section 673.

[87] *Corporations Act 2001* (Cth), ss 655A(5) and 673(5).

[88] In this example, the managing director of Z Ltd was performing in a grossly unsatisfactory manner, to the serious detriment of Z Ltd's profitability. Four fund managers discussed the matter and decided it was an appropriate case for requesting that the board call a general meeting, at which a motion would be proposed that the managing director be removed.

alteration (or potential alteration) to corporate control. The second example given earlier is a case in point.[89]

It is almost beyond argument that the legislature would not have intended Part 6C.1 or section 606 to apply to joint institutional action on matters unconnected to corporate control. Thus, for this class of institutional action there is a very strong case for legislative reform. A possible reform might be to add a "specified exclusion" to those already contained in section 16(1) of the *Corporations Act*. Section 16(1) states: "A person is not an associate of another person by virtue of section 12 or subsection 15(1) ... merely because of one or more of the following: ..." By this mechanism, section 16(1) ensures that certain persons are not deemed to be associates. For present purposes, this would be a means of avoiding the aggregation of each institution's relevant interest in the company's voting shares.

It is not as clear immediately that collective institutional action on matters related to corporate control should be removed from the reach of Part 6C.1 and section 606. Nonetheless, there are at least three arguments in favour of extending the legislative reform suggested in the previous paragraph so it would also cover control-related collective action.

First, the *Corporations Act* contains provisions which reflect a legislative intention that shareholders should be able to act collectively in control-related matters. Section 249D enables shareholders to group together to require the directors to call an extraordinary general meeting, and section 249F empowers shareholders themselves to call a general meeting. Section 249N empowers a group of shareholders to require the company to notify shareholders of a motion to be moved at the next general meeting. And section 249P enables a group of shareholders to require the company to distribute a statement relating to any proposed resolution or business to be dealt with at any general meeting. In addition, and importantly, section 203D

[89] In this example, four fund managers decided to vote against a motion to grant options to an executive director, at an approaching annual general meeting of Z Ltd.

empowers the shareholders of a public company to remove a director, by ordinary resolution, without cause.

Second, the international experience indicates that collective institutional action affecting corporate control should be removed from the reach of Part 6C.1 and section 606. In 1992 the US Securities and Exchange Commission (SEC) amended some of the "proxy rules" made under the *Securities Exchange Act of 1934*, to remove restrictions on the ability of institutional investors to act collectively. The amendments did not, however, remove all of the obstacles.[90] One remaining obstacle stems from a provision (Rule 13d-5(b)(1)) which is similar in effect to Part 6C.1 of the *Corporations Act*. There have been calls for the SEC to reform Rule 13d-5(b)(1), which embraces a concept of a "voting group" which operates remarkably similarly to the "associate" concept in the *Corporations Act*. One influential commentator has submitted:

> [A]t a minimum, the voting group concept should be cut back to exclude shareholders who are engaged in organizing support for a non-control-related vote. ... [I]t is arguable that a solicitation intended to elect only a minority of the [board] seats up for election might be similarly excluded.[91]

In Canada, the takeovers provisions in provincial securities legislation[92] operate similarly to section 606 of the *Corporations Act*. A leading Canadian corporate law scholar has contended:

> There is ... a very strong case for completely exempting institutional owners ... from the application of the takeover rules, unless the ... institutions actively make or participate in an offer to all shareholders. ...

---

[90] See C T Dixon, "The Post-Proxy Reform Era: Remaining Pitfalls for the Unwary Activist Shareholder", *Corporate Governance Advisor*, October/November 1993, at 12; J C Coffee, "The SEC and the Institutional Investor: A Half-Time Report" (1994) 15 Cardozo L Rev 837, at 876-902.

[91] Coffee, ibid at 882.

[92] For example, *Securities Act* 1990 (Ontario), ss 89(1) and 91.

> [C]oordinated institutional activity to influence management on an *ad hoc* basis [should not] be subject to aggregation ... [A]pplying the rules to such conduct will harm all shareholders by interfering with institutional monitoring.[93]

Institutional shareholders in UK companies are probably not faced with the type of legal disincentives currently under discussion. The *Companies Act* 1985 (UK) contains provisions which have the same goal as Part 6C.1 of the *Corporations Act* (disclosure of substantial shareholdings).[94] However, the sections dealing with aggregation of the shareholdings of associated persons (sections 204 to 206) would, in most instances, not catch a coalition of institutions formed to engage in some kind of corporate-governance activity. Section 205 aggregates shareholdings where there is an "agreement"[95] to which section 204 applies. Significantly, section 204 applies only to an agreement which:

> (a) "includes provision for the acquisition by any one or more of [the parties to the agreement] of interests in shares of a particular public company";
> (b) "also includes provisions imposing obligations or restrictions on any one or more of the parties to it with respect to their use, retention or disposal of their interests in that company's shares acquired in pursuance of the agreement"; and
> (c) is fulfilled to the extent that any one or more of the parties actually acquires an interest in the company's shares "in pursuance of the agreement".[96]

---

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

[94] See *Companies Act* 1985 (UK), ss 198-210.

[95] Defined broadly: see *Companies Act* 1985 (UK), s 204(5) and (6).

[96] *Companies Act* 1985 (UK), s 204(1) and (2).

An institutional intervention would not usually satisfy the requirements that there be an agreement to acquire, and then an agreement-related acquisition of, an interest in the company's shares.[97]

In regard to takeover regulation, Rule 9.1 of the UK's *City Code* requires that the shareholdings of "persons acting in concert with" a person must be aggregated with the shareholding of that person when determining whether a takeover bid must be made by that person (the threshold being 30 per cent of the voting rights).[98] At first glance, this provision might seem to have an effect on collective action by institutional shareholders similar to section 606 of the *Corporations Act*. But that is almost certainly not the case. The *City Code* is a non-statutory document - administered, interpreted, and enforced by the Panel on Takeovers and Mergers, a body "composed ... of market professionals in the securities industry [which] prides itself on its speed and lack of formality ... and normally ... does not allow representation by legally skilled persons."[99] It seems very unlikely that the Panel would adopt a legalistic and technical approach to Rule 9.1 of the *City Code* so as to force a coalition of institutions engaged in a corporate-governance action to make a mandatory bid.[100]

The third argument in favour of including control-related collective institutional action within the reform proposed earlier is that there is little

---

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

[98] Panel on Takeovers and Mergers, *The City Code on Takeovers and Mergers*, Rule 9.1.

[99] D D Prentice, "Regulation of Takeover Bids in the United Kingdom" in K Kreuzer (ed), *Öffentliche Übernahmeangebote* (Nomos, 1992), p 139.

[100] This view is reinforced by one of the Panel's own interpretative notes: see above n 67, Notes on Rule 9.1, Note 2: "The Panel does not normally regard the action of shareholders voting together on particular resolutions as action which of itself should lead to an offer obligation."

reason to expect Australian institutions to interfere inappropriately in control-related matters if the legal barriers under discussion were removed. There are numerous *economic* disincentives to detailed involvement by institutional investors in corporate governance.[101] These would continue to act as a forceful restraint on collective institutional action even if the legal barriers relating to section 606 and Part 6C.1 were dismantled.

For these reasons, it is recommended that the *Corporations Act* should be amended so as to protect from the reach of section 606 and Part 6C.1 both non-control-related and control-related institutional action of a collective nature.

INSIDER TRADING

Insider trading has been outlawed in Australia, by way of specific legislation, since the 1970s.[102] Investment fiduciaries need to be familiar with the insider trading prohibitions, particularly given that the provisions can be breached where a fund manager buys (or sells) some shares, even though not personally in possession of any inside information, but where her colleague a floor below possesses inside information about the company concerned. There can be a breach even if the first fund manager does not know that her colleague possesses the inside information.[103]

---

[101] See, eg, J C Coffee, "Liquidity Versus Control: The Institutional Investor as Corporate Monitor" (1991) 91 Colum L Rev 1277; Coffee, above n 90; J C Coffee, "The Folklore of Investor Capitalism" (1997) 95 Mich L Rev 1970; E B Rock, "The Logic and (Uncertain) Significance of Institutional Shareholder Activism" (1991) 79 Georgetown LJ 445; Stapledon, above n 1, ch 10.

[102] See now *Corporations Act 2001* (Cth), Part 7.10, Div 3.

[103] Under *Corporations Act 2001* (Cth), s 1042G, a body corporate (eg fund management firm) is taken to possess any information which an officer of the body corporate possesses and which came into his or her possession in the course of performing his or her duties as an officer. The "Chinese Wall" exemption in section 1043F provides protection in some circumstances.

There are three separate forms of insider trading:

- where someone who possesses non-public price-sensitive information in relation to a company buys or sells the company's shares on the secondary market, or subscribes for them in a primary offer (the "trading offence");

- where someone who possesses non-public price-sensitive information in relation to a company procures someone else to buy or sell the company's shares on the secondary market, or subscribe for them in a primary offer (the "procuring offence"); and

- where someone who possesses non-public price-sensitive information in relation to a company communicates the inside information to someone else, and they know or should know that that other person will be likely to buy or sell the company's shares on the secondary market, subscribe for them in a primary offer, or procure a third person to do one of those things (the "tipping offence").[104]

There is no crime in an institutional investor becoming a party to inside information - so long as it does not trade on it, procure another party to trade in the shares, or communicate the information to another party. It is, nevertheless, arguable that the insider trading provisions serve to restrict the amount of corporate governance activity performed by institutional shareholders. The line of reasoning is as follows:

> [I]nstitutional investors ... cannot trade on some information which is subject to insider trading legislation. As a precaution they do not acquire it in the first place in order to not jeopardize their trading strategy. As a result they stay less informed, thereby reducing their effectiveness as monitors.[105]

[104] *Corporations Act 2001* (Cth), s 1043A.

[105] E Maug, "Institutional Investors as Monitors: On the Impact of Insider Trading Legislation on

However, it is far from clear that the insider trading provisions actually cause institutions to conduct significantly less monitoring of investee companies than they would conduct if the practice were allowed. First, the legislation is not a barrier to routine meetings between fund managers and corporate managements. One-to-one meetings, "roadshow" presentations, and brokers' lunches are all prevalent in Australia. Second, it is difficult to see how the legislation could stymie interventions to replace board members, because institutions only take part in such activism after deciding not to sell their shares at the prevailing price. Third, although inability to trade the shares is cited commonly as a reason why institutions oppose the idea of non-executive directors being nominated by institutional shareholders, a Chinese Wall could be utilised to enable an institution to trade the shares of a company at which one of its fund managers or a nominee was a non-executive director.[106] It appears that the most likely point of impact of the insider-trading provisions is in relation to the "pre-marketing" of proposed large transactions. As one Australian fund manager has said:

> When a company comes to us and says, "We are thinking of doing such and such, what do you think?" we are insiders and that can be to the detriment of [our] clients because we are precluded from acting in the market. So, before the discussion, we typically ask the question, "Will this make us an insider?" ... [I]f we have made a decision ... to buy shares in the company, we may say "We would prefer not to hear what you have to say."[107]

Large Shareholder Activism" (London Business School, 1995).

[106] See *Corporations Act 2001* (Cth), s 1043F; also s 1043C (exception for underwriters). In addition, there are several other reasons usually given by institutions when explaining their antipathy to the concept of having their nominees serve as non-executive directors: see Stapledon, above n 1, chs 5, 8. These other factors would remain as strong disincentives to institutional investor representatives serving as non-executives even if there were no insider trading legislation.

[107] AIST, above n 61 at 114.

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

> Generally we don't decline to discuss the matter. At the end of the day it all gets back to [our] clients' interests ... I think generally the more we know about what is going on in the company the better we are able to make judgements about ... the executives and also the quality of the non-executive directors.[108]

Most institutions are willing to be made insiders in this way for only a few days at most.[109] It might be argued that without the prohibition on insider trading they would be able to become involved at an earlier stage - with resulting benefits for corporate governance. However, it is likely that, even in the absence of the legislation, a company's management would divulge non-public price-sensitive information to an institutional shareholder only if the institution first gave an undertaking not to trade in the shares until the information became public.[110] The desire for freedom to trade would ensure the same relatively short period during which the institution would be happy to be an insider.

SHADOW DIRECTOR

If the directors of a company are accustomed to act in accordance with an institutional investor's instructions or wishes, the institutional investor is deemed to be a director of that company.[111] This is commonly called the "shadow director" concept.

---

[108] Ibid.

[109] Finding of Stapledon's 1994 interview study.

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

[111] *Corporations Act 2001* (Cth), s 9 (definition of "director").

An institutional investor which is a shadow director is subject to most of the provisions of the *Corporations Act* to which a formally appointed director is subject. Two significant examples are the insolvent trading provisions[112] and the statutory officers' duties.[113]

Whether an institutional investor *is* a person in accordance with whose instructions or wishes the board is accustomed to act should be determined from the point of view of the board.[114] However, when a company is the subject of an intervention by one or more institutional investors, it is often the case that the board *resists* the institutions' suggestions, rather than acting in accordance with them. One exception is where a board agrees to appoint new directors suggested by the intervening institutions (as occurred at Coles Myer in 1995). Even in this situation, though, it is unlikely that any of the intervening institutions would fall within the shadow director definition. The one-off action of the board in appointing the new directors would probably not render any of the intervening institutions a person whose instructions the board is *accustomed* to follow. To be a shadow director there must be "a pattern of behaviour".[115] An occasional instance of compliance is insufficient.[116] It should be borne in mind that intervening institutions invariably disengage themselves from active involvement once the board has been reconstituted.

---

[112] *Corporations Act 2001* (Cth), ss 588G to 588U.

[113] *Corporations Act 2001* (Cth), ss 180-183.

[114] *Standard Chartered Bank of Australia Ltd v Antico* (1995) 18 ACSR 1, at 65-71; *Dairy Containers Ltd v NZI Bank Ltd* (1995) 7 NZCLC 260,783, at 260,810-260,811; D D Prentice, "Directors, Creditors, and Shareholders" in E McKendrick (ed), *Commercial Aspects of Trusts and Fiduciary Obligations* (Oxford University Press, 1992), p 81 n 39.

[115] *Re Hydrodan (Corby) Ltd* [1994] BCC 161, at 163. On the other hand, it is not necessary to show that the board followed the instructions or wishes over the entire scope of its activities: *ASC v AS Nominees Ltd* (1995) 18 ACSR 459, at 508-510; *Secretary of State for Trade and Industry v Deverell* [2000] 2 WLR 907.

[116] P M C Koh, "Shadow Director, Shadow Director, Who Art Thou?" (1996) 14 C&SLJ 340, at 343.