

**Institutional Investors and Corporate Governance:
A New Zealand Perspective**

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by

Aik Win Tan and Trish Keeper

Professional Summary

In recent years there has been a dramatic increase in the literature promoting increased institutional investor activism in the corporate governance of the companies in which they invest ('investment-companies') and in the overall shareholding by institutional investors in such companies. However, although we find there has been little research into the incidence or role of institutional investors in New Zealand, commentators suggest that the position in New Zealand likely reflects the characteristics of such investors in comparable jurisdictions. Research from the United States, the United Kingdom and Australia indicates that institutional investors do share some unique characteristics, but care must be taken that they are not viewed as a homogeneous group.

We then examine the principal arguments put forward to justify why institutional investors should be active in the governance of investment-companies. These arguments are summarised into two principal categories, namely enhancement of the performance of the investment-company and improvements in the governance of that company. However, although the literature has focused on reasons why institutions should intervene, there has been less discussion on whether such investors can intervene. Accordingly we discuss in the New Zealand the legal and economic constraints against increased involvement. The legal barriers include the broad definition of director in the Companies Act 1993, which includes

shadow directors or persons in accord with whose instructions the directors may regularly act; the problems of association under the Takeovers Code and the competing legal duties of certain institutional investors. We conclude that that the proposition for institutional investors to be active shareholders is more normative than realistic, given both the legal and economical barriers that actively discourage intervention by institutions in their investments. Finally we suggest that although legal impediments can be reduced through the passing of new legislation, the economic impediments are harder to overcome.

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I INTRODUCTION

In recent years there has been an increasing expectation that institutional investors should become more active in the corporate governance of companies in which they invest. The plethora of renowned corporate governance failures in the last decade has only added to this expectation. The first part of this paper examines the central arguments supporting increased institutional shareholder activism in corporate governance. The paper then explores, in the New Zealand context, the constraints against increased involvement and argues that the proposition for institutional investors as active shareholders is more normative than realistic, given both the legal and economical barriers that actively discourage intervention by institutions in their investments.

II INSTITUTIONAL INVESTORS AND CORPORATE GOVERNANCE¹

A The Incidence of Institutional Investors in New Zealand Equity Markets

In New Zealand there has been comparatively little research on the role that institutional investors perform in the corporate governance of companies in which they invest (in this paper referred to as ‘investment-companies’). Reasons for this are unclear and may simply reflect the relative paucity of research in general on the incidence and nature of institutional investors as equity holders in New Zealand. The quantitative research that has occurred does confirm that New Zealand is following the trends, observed in the United Kingdom (UK), the United States (USA) and Australia from the 1960’s onwards, that institutional investors are an increasingly significant holder of equity. For in the USA, Gompers and Metrick² found that institutions increased their ownership of publicly traded shares measured at market value from 51.6 percent in the year 1996 to 80 percent in the year 2000. In the year 2005, equity control in the largest 1,000 US companies by institutional investors stood at 67.9 percent

¹ See John Farrar, *Corporate Governance – Theories, Principles and Practice* (3 ed, OUP, Melbourne, 2008) 351; Paul Ali, Geof Stapledon and Martin Gold *Corporate Governance and Investment Fiduciaries* (Lawbook Co, Sydney, 2003); Lucian Bebchuk “The Case for Shareholder Access to the Ballot” (2003) *The Business Lawyer* 43; Stuart Gillan and Laura T Starks “Corporate Governance, Corporate Ownership and the Role of Institutional Investors: A Global Perspective” (2003) 4; Stephen Bainbridge “Director Primacy and Shareholder Disempowerment” (2006) 119 *Harvard Law Rev* 1735; Bernard S Black and John Coffee “Hail Britannia? Institutional Investor Behaviour under Limited Regulation” (1993) 92 *Mich. L. Rev.* 1997; Robert A Monks & Nell Minow *Corporate Governance* (3rd ed, Blackwell Publishing, Oxford, 2004) 126-185; Theodor Baums, et al (eds) *Institutional Investors and Corporate Governance*, (Walter de Gruyter, Berlin, 1994) and Geof Stapledon *Institutional Shareholders and Corporate Governance* (Clarendon Press, Oxford, 1996).

² Paul Gompers and Andrew Metrick “Institutional Investor and Equity Prices” (2001) 116 *Quarterly Journal of Economics* 229, 229.

(2000: 19.7 percent) and was valued at US\$24.1 trillion.³ In the UK, institutional investors, between 1990 and 1995, owned about 61-70 percent of listed UK companies.⁴ In Australia in 1988 institutional investors owned approximately 37 percent of Australian equities although this figure may be understated given the difficulty in attempting to trace investments made via nominee entities.⁵ The available statistics for New Zealand indicate that between 1962 and 1974, financial institutions raised their equity ownership from 18 percent to 33 percent while between 1974 and 1981, insurance companies increased their investment in shares to 52 percent from 38 percent.⁶ Unpublished research by Aik Win Tan in 2007 indicated institutional investors' ownership of shares in New Zealand listed companies to be approximately 51%.⁷ However, data collection is made difficult as research in these areas tends to group Australia and New Zealand as one economy for analytical purposes.⁸

B Institutional Investors: An Explanation

The term 'institutional investor' is described by Farrar⁹ as a broad term that "encompasses pension and superannuation funds, investment companies, mutual funds and unit trusts, insurance companies, banks and charitable foundations. It also includes funds managers who are professionals managing investments on behalf of other institutional investors."¹⁰ It is a term that is used to describe a variety of business structures that are "not a monolithic whole

³ Murray Carlson and others "Share Ownership: The Foundation of Corporate Governance" (2004) 4 The Journal of Investment Compliance 54, 57; Anonymous "Institutional Ownership Continues to Climb" (2007) 13 Business Finance, 12.

⁴Jill Solomon and others "Institutional Investors View on Corporate Governance Reform: Policy Recommendations for the 21st Century" (2000) 8 Corporate Governance: An International Review 215; Robert Webb and others "Problems and Limitations of Institutional Investor Participation in Corporate Governance" (2003) 11 Corporate Governance: An International Review, 65; John Farrar *Corporate Governance* (3 ed, OUP, Melbourne, 2008), 362-3 and Christine Mallin *Corporate Governance* (2nd ed, OUP, Oxford, 2007) 81.

⁵John Farrar, *Corporate Governance – Theories, Principles and Practice* (3 ed, OUP, Melbourne, 2008) 362-264; Paul Ali, Geof Stapledon and Martin Gold *Corporate Governance and Investment Fiduciaries* (Lawbook Co, Sydney, 2003) 3.

⁶New Zealand Institute of Economic Research *Equity Investment in New Zealand* (1983), 27; and John Farrar & Mark Russell *Companies Law and Securities Regulation in New Zealand* (Butterworths, Wellington, 1985) states at 290-291 that institutional investors increased their respective holdings in 43 of the major listed companies in 1962 from 17 percent to 33 percent in 1974.

⁷ See Tan, *Corporate Governance and Earnings Quality* (2007) 14. This work was submitted to meet the course requirements of Victoria University of Wellington, Bachelor of Commerce, Honours Course, ACCY401 and is not refereed. Data collection was based on "non-human" shareholders in the listed companies' top 20 shareholders according to annual reports for year ending 2006.

⁸ See Institutional Shareholder Services, *2006 Global Institutional Investor Study* (2006), 42.

⁹ Farrar, above n 5.

¹⁰ Farrar, above n 5, 362. See also Jill Solomon *Corporate Governance and Accountability* (2 ed, John Wiley & Sons, Chichester, 2007) 109 for discussion of institutional investors.

with one investment objective”¹¹, but nevertheless share a number of similarities that distinguish such investors from other shareholders. In a legal sense however there is no distinction between different types of shareholders as the Companies Act 1993 (the Act) simply defines a shareholder as “a person whose name is entitled to be entered in the share register of a company”.¹² Even the requirement to disclose substantial shareholding, as set out in the Securities Market Act 1988, applies the term “shareholders” rather than any reference to ‘institutional investors’.¹³ This lack of acknowledgement in corporate and securities law, as will be discussed below, is a significant legal barrier to institutions taking a more activist stance in relation to their investments.

Farrar’s classification of institutional investors does highlight the absence of heterogeneity of such investors as class. For just as ordinary shareholders can be broadly classified as ‘punters’, ‘bondholders’ or ‘business buyers’, institutional investors differ from investor to investor.¹⁴ There has however been a tendency in overseas research, especially research involving empirical analysis of significant associations between institutional ownership and good governance, to treat institutional investors as a homogenous group of shareholders.¹⁵ By assuming homogeneity, academic literature maybe drawing inaccurate assumptions on the incentives and motivation for various institutions to take on active roles in the governance of their investment-companies. Authors like Barnard,¹⁶ Ryan and Schneider,¹⁷ and Monks and Minnow¹⁸ have debated the differences that exist between institutions like public pension funds and mutual funds. For example mutual funds, as active traders, are assumed to be less involved with governance and more concerned with profit-

¹¹ Farrar, above n 5, 362.

¹² Companies Act 1993, s 96(a).

¹³ Securities Market Act 1988, subpart 3, requires substantial shareholders (5 percent and above ownership of shares) to disclose and notify, in a prescribed form, their relevant interests and to further disclose and notify, in a prescribed form any changes to their relevant interest in public issuers if these changes affect their relevant interests by more than 1 percent.

¹⁴ Bruce Sheppard “Has the Shareholders’ Association Created Value” (2007) Boardroom 1, 2.

¹⁵ For example of empirical work involving homogenous assumptions of institutional investors, see Ping-Sheung Koh and Grace S Hsu “Does the Presence of Institutional Investors Influence Accruals Management? Evidence from Australia” (2005) 13 Corporate Governance 809; Gregory Kane and Uma Velury “The Role of Institutional Ownership in the Market for Auditing Services: An Empirical Investigation” (2002) 57 Journal of Business Research 976. Also, see generally, Kevin Hendry and others “Owners or Traders? Conceptualisations of Institutional Investors and their Relationship with Corporate Managers” (2006) 59 Human Relations 1101 and Andrew M Clearfield “With Friends Like These, Who Needs Enemies? The Structure of the Investment Industry and its Reluctance to Exercise Governance Oversight” (2005) 13 Corporate Governance, 114.

¹⁶ Jayne Barnard “Institutional Investors and the New Corporate Governance” (1991) 69 N C L Rev. 1135, 1142.

¹⁷ Lori Ryan and Marguerite Schneider “Institutional Investor Power and Heterogeneity” (2003) 42 Business and Society 398,402.

¹⁸ Robert Monks & Nell Minnow, *Corporate Governance* (3rd 3d, Blackwell Publishing, Oxford, 2004) 129-160.

making. Even within similar classifications, certain public pension funds are more active than others. The California Public Employees' Retirement System (CalPERS) is known for its vocal stance towards governance and performance improvements compared to other institutions.¹⁹

Institutional investors generally do have some characteristics that make them unique and distinct shareholders. Firstly, institutional investors typically hold shares as part of a portfolio investment strategy as can therefore be distinguished, at least commercially, from other shareholders. A second and related point, is that although ownership of shares in investment-companies, is legally attributable to the institution, the shares are economically attributed to the ultimate investors and clients of the institution.²⁰ Institutions are financial intermediaries who do not hold the shares for their own benefit as the financial returns are distributed to their investors and clients. Moreover, institutional ownership of shares may be made more complex when institutions, through various related investments in other institutions, actually invest back into their own funds. This circular investment is unique to institutions given their broad range of investment preferences and client-types.

Finally, although institutional investors have increased their ownership of shares in many public listed companies across various countries in recent times, it is important to note that institutional investors are distinct from major or controlling shareholders. While institutional investors hold more shares compared to an ordinary individual shareholder, the holdings are generally not large enough to provide the institution with controlling rights. The increasingly large shareholding by institutional investors as a group is divided among numerous individual mutual funds, pension plans, insurance firms, banks and nominee companies. Institutional investors typically hold small parcels of shares as seeking control rights within their investments defeats the purpose of risk diversification. For example, unit trusts and private pension plans hold small shareholdings across a diverse range of investment-companies to provide their clients protection against unnecessary risks.

¹⁹ Michael Useem *Investor Capitalism* (Basic Books, New York, 1996); Murray Carlson and others "Share Ownership: The Foundation of Corporate Governance" (2004) 4 *The Journal of Investment Compliance* 54; Monks and Morrow, above n 147.

²⁰ Jill Solomon *Corporate Governance and Accountability* (2 ed, John Wiley & Sons, Chichester, 2007) 119.

C Shareholders and Corporate Governance

From a legal and historical perspective, shareholders play the role of owner-investor in relation to the company through payment of money for shares via an agreement between the shareholder and the company.²¹ Yet, the term “shareholder as owner” is misleading as shareholders are not accorded full ownership rights. Due to the separation of ownership and control in modern corporations, shareholders are owners without property rights in relation to the company’s assets. In exchange for limited liability, shareholders’ property rights have been limited to their shares in the company while property rights and control over corporate assets are placed in the hands of the board of directors and senior management. Court decisions like *Macaura v. Northern Assurance Co Ltd*²² have reinforced this concept of separation by refusing to allow shareholders to extend their proprietorship to certain corporate assets. In addition, in outsider systems such as the USA and the UK, shareholders are traditionally viewed as powerless to prevent the self-interested actions of directors and senior management, due to the diffused ownership structures of large companies, the high economic costs of shareholder activism, free-rider problems and inability to influence voting mechanisms.²³ However the change in investment patterns as discussed above has “challenged some of the fundamental preconceptions about corporate governance, the role of shareholders in public companies and corporate regulation itself.”²⁴ This need to challenge established attitudes to corporate governance has been further strengthened by the spate of recent corporate transgressions such as WorldCom and Enron in the United States (US) and HIH in Australia highlighting endemic failures by both directors and auditors in their duties to protect shareholders’ wealth and interests. In this context, the emergence of institutional investors as a new breed of shareholders, have been trumpeted as the “saviours” of shareholder rights through as through a combination of their size, concentrated share ownership, good reputation and access to a broad range of financial resources they are able to overcome the problem of shareholder apathy. Although, in fact the call for institutional involvement is not something new. Berle, in 1928, had urged banks to act as “permanent protective committees” to negotiate for then undisclosed financial information and protect

²¹ New Zealand Companies Office <<http://www.companies.govt.nz/cms/customer-support/glossary>> (last accessed 22 April 2008).

²² *Macaura v. Northern Assurance Co Ltd* [1925] AC 619 (HL).

²³ Lucian Bebchuk “The Case for Shareholder Access to the Ballot” (2003) *The Business Lawyer* 43, 64; Stuart Gillan and Laura T Starks “Corporate Governance, Corporate Ownership and the Role of Institutional Investors: A Global Perspective” (2003) 4, 6; and Stephen Bainbridge “Director Primacy and Shareholder Disempowerment” (2006) 119 *Harvard Law Rev* 1735, 1745.

²⁴ Jennifer Hill and Ian Ramsay “Institutional Investment in Australia: Theory and Evidence” in Gordon Walker and Brent Fisse (eds) *Securities Regulation in Australia and New Zealand* (OUP, Auckland, 1994) 289.

depositors from managerial abuse “thereby gathering many small holdings...commanding a block so large that protection was worthwhile...to prevent or rectify violations of property rights where they occurred”.²⁵ In summary, some commentators contend that institutional investors can “potentially resurrect the role and interests of shareholders” – something seen as a “return to Eden by some scholars”.²⁶ The lines of reasoning supporting increased institutional activism can be divided into the two broad categories, namely performance enhancement and governance improvement. These are discussed further below.

III. WHY INSTITUTIONAL INVESTORS SHOULD BE ACTIVE IN CORPORATE GOVERNANCE

A Performance Enhancement

In terms of performance enhancement, much of academic literature in this area has been empirical work to prove or disprove the associations between institutional ownership of shares and some variable representing performance such as earnings quality or share price. Within academic literature, two perspectives dominate the debate on institutional investors’ influence on corporate results. On one hand, institutional investors are viewed as frequent traders with fragmented investments who rather liquidate their holdings in times of doubt rather than choose to stay on and initiate “rescue plans” to protect shareholders’ wealth.²⁷ This perspective views fund managers as focusing solely on short-term profit rather than the long-term sustainability and viability of their investments. On the other hand, institutional investors are viewed as long-term investors that play active roles in the monitoring and disciplining of managerial decisions in order to improve capital market efficiency and to enhance shareholder value.²⁸ The level of concentrated ownership of shares by institutions in recent years has made the “Wall St. walk” a very costly alternative as institutions would have to offer discounted prices to sell their shares.²⁹ In addition, the increasing use of indexed funds–investment strategies specifically designed to mimic market returns has meant that short-term focus on profit through liquidation of shares is no longer a viable option as such an

²⁵ A Berle, *Studies in the Law of Corporation Finance* (Callaghan & Co, Chicago, 1928), 39.

²⁶ Jennifer Hill “Visions and Revisions of the Shareholder” (2000) 48 *Am J Comp* 39, 61.

²⁷ See David Porter “Capital Choices: Changing the Way America Invests in Industry” (1992) 4 *Journal of Applied Corporate Finance* 4; Viraj M Bhide “The Hidden Costs of Stock Market Liquidity” (1993) 34 *Journal of Financial Economics* 31.

²⁸ Koh and Hsu, above n 15, 810; Carlson and others, above n 3, 56.

²⁹ Carlson and others, above n 3, 56; John Pound “Beyond Takeovers: Politics Comes to Corporate Control” (1992) *Harvard Business Review* 83; Bernard S Black and John Coffee “Hail Britannia? Institutional Investor Behaviour under Limited Regulation” (1993) 92 *Mich. L. Rev.* 1997; Barnard, above n 15, 1151.

alternative will affect the composition and diversification of risk within the indexed fund.³⁰ Furthermore, arguments of short-termism tend to arise from an assumption that institutional investors are all unit trusts that actively trade their shares. This assumption is limited since other large institutions like public pension funds, university endowments and foundations are 'locked-in' to ensure long-term value for their beneficiaries.³¹ Collectively, these disincentives to the "exit" strategy by institutions provide an impetus for continuous intervention to ensure performance.

Koh,³² in a study of associations between institutional ownership of Australian non-financial listed companies and earnings quality, finds a negative relationship between concentration of institutional ownership of shares and income increasing accruals that potentially affect the quality of reported earnings. By maintaining their shareholding, institutional investors are able to affect the quality of information being reported to the public in the long-run. Related to this information-performance perspective, is the ability to ensure market participants are continuously informed of the company's actions. Institutional investors have been found to convey managerial information to other shareholders given the institutions' access to superior private information.³³ Being a long-term shareholder with concentrated ownership, the cost of other shareholders free-riding on the institution's monitoring of performance is reduced by the benefits it receives from enhanced performance of the investment-company.³⁴ Additional support for institutional investors taking a long-term viewpoint is the higher levels of research and development expenses associated with higher institutional ownership.³⁵ Moreover, some authors have argued that institutional investors may be willing to take control of the company or act as "managerial partners".³⁶ The interventionist approach taken by institutions to counter underperformance of companies

³⁰ John Coffee "Liquidity versus Control: The Institutional Investor as Corporate Monitor" (1991) 91 Colum L Rev 1277, 1329.

³¹ Carlson and others, above n 3, 56.

³² Koh and Hsu, above n 15, 810; Ping-Sheung Koh "On the Association between Institutional Ownership and Aggressive Corporate Earnings Management in Australia" (2003) 35 The British Accounting Review 105.

³³ Chidambaram and John "Relationship Investing and Corporate Governance" (2000) Tulane University and New York University Working Paper.

³⁴ Gillan and Starks, above n 23, 7.

³⁵ Brian J Bushee "The Influence of Institutional Investors on Myopic R&D Investment Behaviour" (1998) 73 The Accounting Review 305, 333.

³⁶ Andrei Shleifer and Robert W Vishny "A Survey of Corporate Governance" (1997) 52 Journal of Finance 737; Hill, above n 24, 61.

in recent years is another reflection of institutional investors' inability to dispose shares at will given concentrated ownership and passive investment strategies.³⁷

In addition, institutional investors simultaneously provide benefits to other shareholders through effective monitoring of the performance of their investment-companies. In an investigation of the USA retail industry, Hollowell³⁸ extracted detailed institutional ownership information for 980 companies and statistically analysed the ownership variables against a range of performance measurements. In summary, positive associations were discovered between higher institutional ownership with the level of Board of Director activities (e.g. Board meetings), shareholder wealth gains measured in changes in price for the company's shares and lower agency costs measured by excessive executive remuneration packages.³⁹ Other authors like Nesbitt, and Del Guercio and Hawkins have also discovered positive associations between pension fund interventions (specifically CalPERS) through shareholder proposals and share price performance in excess of the S&P 500 in the long-run.⁴⁰

B Governance Improvement

The second claim is that institutional investors should also play an important role in ensuring good governance of their investment-companies. This argument relies on the fact that such institutions through concentrated ownership of shares, together with the financial strength and expertise of the institution are able to effectively overcome the problem of diffused shareholding. The Cadbury Report⁴¹ specifically states that "given the weight of [institutional investors'] votes, the way in which [the institutions] use their power to influence the standards of corporate governance is of fundamental importance". In practice in recent years, either due to client demands or increasing pressure from governments, institutions have

³⁷ See Hill, above n 26, 72 for a commentary on institutional investor intervention in Goodman Fielder and Coles Meyer in Australia.

³⁸ Hollowell "The Effects of Institutional Investors in the Retail Industry" (2006) 9 Journal of American Academy of Business 27, 28.

³⁹ Hollowell, above n 38, 29.

⁴⁰ Stephen L Nesbitt "Long-Term Rewards from Shareholder Activism: A Study of the CalPERS Effect" (1994) 6 Journal of Applied Corporate Finance 75; Diane Del Guercio and Jennifer Hawkins "The Motivation and Impact of Pension Fund Activism" (1999) 52(3) Journal of Financial Economics 293. Del Guercio and Hawkins, although discovering positive associations, concluded that the associations were not statistically significant.

⁴¹ The Committee on the Financial Aspects of Corporate Governance, *Financial Aspects of Corporate Governance (The Cadbury Report)* (Professional Publishing Ltd, London, 1992), para 6.10.

become more active participants in governance issues through the use of their voting power. Interviews conducted with UK-based investment houses reveal institutional investors are regular participants in voting and discussion of issues concerning executive pay in addition to active engagements with the Board and top management on important strategic matters.⁴² Solomon⁴³ reveals that UK investors have been allowed to vote on a number of remuneration policies in certain companies since 2001 and stresses that this power is limited to the policy itself and not the individual remuneration of management which should be decided by the directors. Through the use of their voting power, institutional investors send strong signals to the business community on their preferences for good governance. As a result, cases like Kingfisher and GlaxoSmithKline in the UK are good examples of institutional investors' intervention when remuneration packages offered were excessive in light of the executives' performance.⁴⁴ The case involving GlaxoSmithKline was an extreme example of institutional investors publicly shaming their investment-companies which resulted in 63 percent of the shareholders voting against or abstaining from the remuneration vote.⁴⁵

Furthermore, institutional investors do pick their investments based on governance characteristics. Interviews conducted in Australia and New Zealand reveal fund managers' strong interest in the composition of the Board of Directors and specifically an interest in boards with a majority of independent directors, separation of Chairperson and CEO and performance-based remuneration for executives.⁴⁶ This trend is confirmed on a global basis through the ISS Global Investor Study which places board structure/composition/independence and executive compensation as the two most important corporate governance issues in the near term.⁴⁷ Through a public declaration of their preferences for corporate governance, institutional investors are able to influence their investment-companies to seek better governance or risk active intervention or shareholder retaliations during annual general meetings. Moreover, budding corporate entities are encouraged to implement good corporate governance to attract investments from institutional

⁴² Kevin Hendry and others "Owners or Traders? Conceptualisations of Institutional Investors and their Relationship with Corporate Managers" (2006) 59 *Human Relations* 1101, 1111.

⁴³ Solomon, above n 20, 123.

⁴⁴ Solomon, above n 20, 124.

⁴⁵ Solomon, above n 20 124.

⁴⁶ Peggy Chiu and John Monin "Effective Corporate Governance: From the Perspective of New Zealand Fund Managers" (2003) 11 *Corporate Governance: An International Review*, 123; Ramsay and others "Corporate Governance: The Perspective of Australian Institutional Shareholders" (2000) 18 *Company and Securities Law Journal*, 110.

⁴⁷ Institutional Shareholder Services, above, n 8, 30.

investors. Corporate governance thus, is no longer about compliance, but a business imperative to attract investments.⁴⁸

However, one must exercise caution in the interpretation of empirical research linking institutional investor ownership of shares to performance measurements. Statistical analyses are only limited to significant *associations* and *not* causality. There are academic literatures that criticise institutional investors' activism for its blind interventionist's approach without much evidence of causation between institutional ownership and increased performance.⁴⁹ Moreover, even if one can find a causal link between institutional ownership and performance, the relationship is an endogenous one.⁵⁰ On one hand, higher institutional ownership may lead to better performance. But on the other, better performance by the investment-company may actually be a drawing point for institutional investors to own shares in the company. Empirical studies that focus on associations do not effectively separate the two and one is unsure of the direction of causality. In addition, institutional investors seem to only intervene in extreme cases where much of the media attention is focused. Although it has been reported that such investors do vote regularly, there are also reports of institutional investors' passivity as indicated by a US poll in 2001 conducted by Thomson Financial where 71 percent of 35 buy-side institutional investors do not anticipate their institutions taking an activist stance in corporate governance issues.⁵¹ Also, the Coles Meyer tussle as discussed in Hill⁵² provides evidence of institutional investors choosing the "exit" strategy rather than persevere with their "voice" as the issue prolonged. Given the mixed and incongruent results from empirical and interview-based studies, it is difficult to draw an absolute conclusion on the importance and effect of institutional ownership within corporate governance. In addition, the literature discussed above is largely normative in nature; arguing that institutional investors *should* intervene without a debate on whether institutions *can* actually intervene. The following sections will discuss legal and economical barriers that discourage institutional investor intervention in New Zealand.

⁴⁸ Institutional Shareholder Services, above, n 8, 5.

⁴⁹ Robert Pozen "Institutional Perspective on Shareholder Nominations of Corporate Directors" (2003) 59 Bus. Law 95, 98. In this article, the author points out the inadequate correlation between institutional investors' influence on board composition and company performance.

⁵⁰ Gillan and Starks, above n 23, 15.

⁵¹ William Shipman "Institutional Investors Reject Role in Corporate Governance Drama" (2002) Wall Street Journal 10.

⁵² Hill, above n 26, 77.

IV THE CONSTRAINTS

A Legal Barriers

The primary legal issue restraining institutional investor activism arises from the fact that corporate and securities law does not secure additional rights or safe harbours for institutional investors who become involved in corporate governance. Rather they are subject to the same level regulation and disclosure as any other shareholder. In fact, corporate and securities law tends to require more onerous disclosures and duties for larger and/or active shareholders in order to protect other (diffused) shareholders. A fact that may inadvertently result in less protection for such shareholders from the consequences of poor corporate governance practices.

1 Shadow director and Director's duties

The New Zealand Companies Act 1993 contains a very inclusive catch-all definition for the position of company director for the purpose of certain duties under the Act. Section 126(1)(a) of the Companies Act 1993 broadly defines a director in relation to a company as including a person occupying the position of director of a company by whatever name called. Further, s126(1)(b)(i) provides that a director is also the person whose directions or instructions a person stipulated in s.126(1)(a) may be required or is accustomed to act. Moreover, if the Board may be required or is accustomed to act on the instructions or directions of a person, this person is also defined as a company director under s126(1)(b)(ii) of the Act. The purpose of such extended definition is to catch advisors and controllers of a board, often referred to as shadow directors. The term 'shadow director' is not defined in the Companies Act 1993 but refers to any person, in relation to a company, has his/her instructions acted upon. Also known as *de facto* directors, shadow directors are those persons who purport to act as directors of a company.⁵³ The risk to any person being caught under this wide definition of "director", whether intentional or not, is the potential liability for breach of director duties under ss131-149. Failure to meet these duties may result in the person being personally liable for the losses of the company regardless of whether the person was an appointed director (*de jure*) or a shadow director (*de facto*).

As the above brief summary of the shadow director provisions in the Companies Act 1993 suggests, institutional investors may incur risks when steps taken to improve the

⁵³ *Re Hydrodan (Corby) Ltd (in liq)* [1994] 2 BCLC 180; [1994] BCC 161.

governance of their investment companies are interpreted as instructions that are acted upon by a Board. Although institutional investors, especially those with passive indexed funds, hold small shareholdings within each investment-company, such institutional investors may affect the decisions that appointed directors make and thus, potentially result in institutional investors being construed as shadow directors. Institutional investors may affect the decisions taken by company directors through their visibility in the popular press, vast financial and professional resources, analysts' reports and general influence on the market for securities. Moreover, section 126 not only captures shadow directors whose actual instructions have been acted upon, but merely requiring the board to act will suffice in defining institutional investors as *de facto* directors. For institutional investors, the line between influence and control, monitoring and managing and requests and orders can be a very fine one. The rewards may not commensurate the risks, if in intervening, institutional investors expose themselves to potential liabilities for breach of director duties when situations turn bad.

2 *Insider trading*

Under the Securities Market Act 1988 as amended by the Securities Markets Amendment Act 2006⁵⁴ a person has inside information in relation to a public issuer if they are information insider of that entity. An information insider under s 8A is someone who has material information⁵⁵ relating to that entity that is not available to the market and knows or ought to know that the information is material and that it is not generally available to the market.⁵⁶ Therefore, the key determinant of what is inside information is the nature of the information used for trading. If someone is an information insider, that person must not disclose and trade or advise or encourage trading on inside information if the person is an information insider of the public issuer.⁵⁷ Although the amended provisions have only recently come into force, it would seem that institutional investors face a greater risk of being liable for insider trading under the new regime. Firstly, someone will now be classified as an information insider based on the type of information held rather whether that information was gained through a relationship with a public issuer. Secondly, actual knowledge is not needed

⁵⁴ Securities Markets Amendment Act 2006 Commencement Order 2007 (SR 2007/367) cl 2 stated that the new Part 1 of the Act as set out in the Securities Markets Amendment Act 2006 (2006 No 47), replaced in full the existing Part 1 of the Act from 29 February 2008.

⁵⁵ See s 3 for an extended definition of what is material information in relation to a public issuer.

⁵⁶ See s 4 for an extended definition of when information is generally available to the market.

⁵⁷ Securities Market Act 1988, s 8 and ss 8C-8E.

as the standard of “ought reasonably to have known” is imposed. As a result, the scope for inadvertent insider trading has been widened by the 2006 amendments. Both changes, combined with the primary business of institutional investors to trade, place institutional investors at risk when taking active positions in relation to the governance of their investment-companies as material inside information will most likely be divulged.

It is not difficult to perceive situations where institutional investors may be entangled with the insider trading provisions given their potential access to superior private information not available to other shareholders.⁵⁸ When institutional investors, as part of their normal routine, hold meetings with senior management from their public investment-companies to discuss strategy and performance, private information with material impact on the share price could potentially be discussed. Inadvertently, institutional investors may trade on that information and be liable for insider trading. Although institutional investors may attempt to avoid exposures of private information that limits their ability to trade, the risk for insider trading remains for large institutional investors.⁵⁹ Additionally, large institutional investors have complex structures and offer a diverse range of financial services to their clients who may be investment-companies within their portfolios. As a result, private information that flows from one division to another division within the same institution may result in insider trading. This could occur even without a conscious realisation by the various managers within the institution. Thus, institutional investors are limited in their governance role as queries on sensitive but important issues may result in inside information being attributed to the institutional investor. However, various control mechanisms like “Chinese-Walls” may be designed to counter problems related to the flow of private information within large institutions. These mechanisms, as will be discussed below, do have their limitations and uncertainties.

Moreover, an additional deterrent against being “too relational” with their investment-companies are the criminal liabilities that any information insider faces under the amended Act.⁶⁰ Section 8F of the Securities Market 1988 (as amended) stipulates that those found for insider trading under the Act commits an offence and under Section 43, individuals can be imprisoned for up to 5 years and fined up to NZ\$300,000 while a body corporate can be fined

⁵⁸ Chidambaran and John, above n 33.

⁵⁹ Hendry and others, above n 42, 1110.

⁶⁰ Securities Market Act 1988, s 8F.

up to NZ \$1,000,000. Although institutions may use any of the affirmative defences provided under the amended Act, the reputational and legal costs of court proceedings may be a sufficient deterrent for institutions to avoid the position of an information insider at the first instance.⁶¹

However, certain defences may be utilised by institutional investors when accused of insider trading. One of these defences includes the establishment of a “Chinese-Wall”, a defence that has been retained, albeit slightly amended by the 2006 reforms. A “Chinese-Wall” is an arrangement that ensures no individuals who took part in the trading activity had access to the inside information or was influenced by a person who had the information.⁶² It is not sufficient that an entity has Chinese Wall arrangements in place, the defence also requires that no individual who traded had access to inside information or were influenced by a person who had the information.⁶³ The limitation of this defence lies in proving the effectiveness of the “Chinese-Wall”. The New Zealand Securities Commission is not required to give approval to any “Chinese-Wall” and it remains a question of fact before the Courts after the trading had occurred.⁶⁴ Although cases like *Australian Securities and Investments Commission (ASIC) v Citigroup Global Markets Australia Pty Ltd (No 4)*⁶⁵ have provided guidance in determining the effectiveness of a “Chinese-Wall”, large institutional investors still bear the potential risk for inadvertent insider trading as the effectiveness of any “Chinese-Walls” can only be determined *ex-post* after the transaction and only through costly litigation before the Courts.

3 *Complications with the Takeovers Code*

The Takeovers Code 2001 (New Zealand) is enforced by the Takeovers Panel whose functions are detailed under Section 8 of the Takeovers Act 1993. These functions mainly relate to reviewing takeovers of code companies, to make recommendations to the Minister of any changes to the law if necessary, to enforce the provisions of the Takeovers Act 1993 and

⁶¹ Securities Market Act 1988, ss 10-10D.

⁶² Securities Market Act 1988, s 10 D.

⁶³ Securities Market Act 1988, s 10D(1)(b).

⁶⁴ Susan Watson and others, *The Law of Business Organisations* (Palatine Press, Wellington, 4th ed., 2003), 504-505.

⁶⁵ *Australian Securities and Investments Commission (ASIC) v Citigroup Global Markets Australia Pty Ltd (No 4)* [2007] FCA 963.

to educate the public about the law and practices relating to takeovers.⁶⁶ The Takeovers Act 1993 and the Takeovers Code 2001 (the Code) were designed to ensure equity (*pari passu*) for all shareholders in the event of an offer for the securities of a code company. If no such procedures to regulate the process of takeovers were in place, minority shareholders may be disadvantaged when purchasers, wanting to gain the controlling block of shares, offer controlling shareholders a premium for their shares although the shares are the same class of shares as held by the minority shareholders. However, what the Code does not foresee are situations where institutional investors band together on governance matters and pool their voting rights to defeat managerial resolutions that divert shareholder wealth.

The issue arises out of the definition of “associate” under Section 4 of the Code which defines an associate of another person to include persons acting jointly or in concert or a person who acts, or is accustomed to act, in accordance with the wishes of another person.⁶⁷ Under the fundamental rule of the Code, a person without voting rights or with less than 20 percent of the voting rights in a code company may not become holder or controller of an increased percentage of voting rights in the code company unless, after that event (the takeover), the person and the person’s associate hold or control not more than 20 percent of the voting rights in the code company.⁶⁸ Furthermore, persons with 20 percent or more of the voting rights in the code company may not increase their percentage of voting rights in the code company unless specific provisions of the Code are adhered to.⁶⁹ Control and controller for the purposes of this provision are defined as direct or indirect effective control of the voting rights in the code company.⁷⁰

As a result, if institutional investors band together and act in concert to defeat resolutions that they perceive as not in the best interest of the shareholders, the institutional investors risk being defined as associates within the ambits of the Code given the pooling of their voting rights. If, by acting in concert for corporate governance matters, institutional investors as a group garner more than 20 percent of the voting rights (which is very likely given the need for a majority to defeat any resolutions), the Code’s specific provisions for Offers and Procedures for Offers may be triggered. As such, there is a risk that institutional

⁶⁶ Takeovers Act 1993, s.8.

⁶⁷ Takeovers Code Approval Order 2000, Takeovers Code rr.4(1)(a)-(b).

⁶⁸ Takeovers Code Approval Order 2000, Takeovers Code, r 6(1)(a).

⁶⁹ Takeovers Code Approval Order 2000, Takeovers Code, r 6(1)(b).

⁷⁰ Takeovers Code Approval Order 2000, Takeovers Code, r 3(1).

investors are interpreted as increasing their voting rights without providing an offer in the prescribed form under the Code. Moreover, if institutional investors meet the definitions of associate under the Code, any institutional investor in that group can be deemed controller or holder of those voting rights.⁷¹ A hypothetical example of this can occur when three institutional investors A, B and C; each holding 10 percent of the voting rights, agree to vote their shares against the company's executive remuneration package. If found to be associates for the purposes of the Code, A may be deemed controller or holder of B and C's voting rights with the same being applied to B and C. This example also depicts how an institutional investor with less than 20% voting rights could trigger the Code provisions just by acting in concert to pool its voting rights with other institutional investors. As a result, institutional investors may expose themselves to risks of litigation from other shareholders or any other person who suffered a loss due to the institutional investors' action in the pooling of their voting rights. The Takeovers Act 1993, under ss 33I-33R,⁷² allow Courts to order compensations, pecuniary penalties and costs which are likely to discourage institutional investors to intervene in the code company's governance without first receiving substantial professional advice.

However, the above New Zealand scenarios may not occur in Australia. The Australian Securities and Investments Commission (ASIC) have created a Class Order granting conditional relief to enable institutions to liaise and agree in collective voting at particular company meetings.⁷³ Whether or not institutions have an agreement to collectively vote on a particular issue at a particular meeting of the company is to be decided by the ASIC although waivers for specific situations can be granted.⁷⁴ The relief under the Class Order is very prescriptive and requires strict adherence or risk investigations by the ASIC.⁷⁵

4 *Disclosure of Substantial Shareholding*

Under the Securities Market Act 1988, any person in relation to a public issuer who has a relevant interest of 5 percent or more of the voting securities of that public issuer is

⁷¹ Takeovers Code Approval Order 2000, Takeovers Code, r 6(3)(a)-(c).

⁷² Sections 33F to 33R were inserted, as from 25 October 2006, by s 16 Takeovers Amendment Act 2006 (2006 No 48).

⁷³ Farrar, above n 5, 366.

⁷⁴ Farrar, above n 5, 366.

⁷⁵ Farrar, above n 5, 366.

deemed to be the issuer's substantial security holder.⁷⁶ If a person is or becomes a substantial security holder in a public issuer, the person must give notice to the public issuer and any relevant registered exchanges in a prescribed form containing prescribed information as stipulated under the Act.⁷⁷ The same requirement applies if the relevant interest of the substantial security holder in the public issuer changes by 1 percent or more or the nature of the substantial security holder's relevant interest changes due to some event.⁷⁸ The underlying purpose for these disclosures is due to the market requiring information in order for it to be efficient and such efficiency is not possible when the identities of those controlling or influencing the company are not made public.⁷⁹ In general, the Securities Market Amendment Act 2006 did not fundamentally change these disclosure requirements.

On first instance, institutional investors with their small shareholdings across a diverse range of companies do not seem to be within the ambit of the disclosure provisions. However, issues arise out of the term "relevant interest" which is defined widely in the Act. For the purposes of this discussion, under the current Act, relevant interest in a voting security exists (whether the person is the holder of the security or not) when a person has the power to exercise or control the exercise of the voting rights to the security which may arise by virtue of any trust, arrangement or understanding relating to the voting rights of the security.⁸⁰ Moreover, where the person or its directors are accustomed or under obligation, whether legally enforceable or not, to act in accordance with the directions of another person with relevant interest in the voting rights of the security, the person is also deemed to have relevant interest in the security.⁸¹ The term "relevant interest" is defined widely to not only include direct legal and beneficial ownership of securities but also indirect control of the said securities.⁸² The wide definition above ensures interrelated parties within a public issuer provide disclosures to the market to enhance market efficiency.

The problem that institutional investors may face arises out of cooperation to vote as one joint group or in concert in order to affect the governance of their investment-companies. In having some form of agreement, be it legally enforceable or not, or even some form of

⁷⁶ Securities Market Act 1988, s 21.

⁷⁷ Securities Market Act 1988, s 22.

⁷⁸ Securities Market Act 1988, ss 23-24.

⁷⁹ *Perry Corporation v Ithaca (Custodians) Ltd* 4/11/03, CA43/03.

⁸⁰ Securities Market Act 1988, ss 5-5B.

⁸¹ Securities Market Act 1988, s 5B.

⁸² *Richmond Ltd v PPCS Ltd* (2003) 9 NZCLC 263, 115.

understanding with regards to the voting rights of their securities, each and every institutional investor may have a relevant interest in the securities of the other institutional investors. Inadvertently, given that the provisions attribute relevant interests in securities to each investor, all institutional investors acting together may be required to make disclosures as substantial security holders. A situation may arise where institution A, B and C, each holding 3 percent of the voting securities, being required to make a declaration as substantial security holder given each investor's relevant interest of 9 percent. This situation may discourage institutional investors in cooperating to enhance the governance of their investment-companies through the use of their voting rights as to do so would expose the institutions to the various disclosure rules under the Act. Moreover, following the reforms of the Securities Market Amendment Act 2006, the failure to comply with the disclosure rules is an offence under the Act and may result in a fine to a maximum of NZ \$30,000.

5 *Investment Fiduciaries*

Institutional investors may also be constrained by considerations derived from the legal form of the investor. With regard to managed funds, investors or clients provide cash to a fund manager who "has undertaken to use that consideration to generate financial returns for the benefit of the investor."⁸³ The cash is used to purchase 'investment assets' that are purchased not in the name of the fund manager, but in the name of another party, either a trustee or a custodian on behalf of the trustee.⁸⁴ The effect of such arrangements is that the registered holder of the investment assets, whether it is a custodian or a trustee, holds them on trust for the beneficiaries. Secondly, the registered holder of the investment assets (usually shares) will be normally be required by the investment management contract to vote those shares in accord with the wishes of either the fund manager or the trustee, depending on the specific form of institutional investor. However, a separate issue arises as to whether fund managers or trustees can be required to vote. As has been observed with regard to the Australian investment fiduciaries; unless there is an express contractual obligation, the issue of whether trustees or fund managers have an obligation to vote is regulated by the common law or governing statutory regime.

⁸³ Paul Ali, Geof Stapledon and Martin Gold, *Corporate Governance and Investment Fiduciaries* (Lawbook Co, Sydney, 2003) 7.

⁸⁴ Ali, Stapledon and Gold, above n 83, 8.

Many forms of institutional investors use trusts as the underlying business structure. Trustees of such trusts owe, subject to the general law of trusts, general duties such as the duty of loyalty, duty to act personally and a duty of efficient management. A trustee's duty of care to the trust forms part of the duty of efficient management and requires a trustee to exercise the standard of care of an ordinary prudent businessperson in regard of his or her own business.⁸⁵ A trustee has also a duty to act in what the trustee considers to be the best interests of the beneficiaries of the trust.⁸⁶ None of these general duties mandate that trustees must vote on all occasions that shareholders in an investment-company may be required to vote. For while voting should always be one of the options that a trustee should consider, the trustees are obliged to do no more than inform themselves in order to make a rational decision on behalf of the trust. Clearly, trustees would have in certain circumstances a duty to exercise a voting right, such as when the resolutions would have a material affect on the fund's shareholding. For the trustees of an institutional investor, the prime consideration is what is in the best interests of the investors whose interests they are required to represent. They are not legally required to consider the best interests of other shareholders, nor of the company. Corporate law has recognised that individual shareholders generally do not owe duties to other shareholders or to the company (other than duty to pay for their shares).⁸⁷ Only if shareholders form part of the majority, do they owe a duty to act without oppression on the minority⁸⁸ Further, in New Zealand, there is no fiduciary duty on controlling shareholders as found in some USA corporation law.

The above sections have presented the legal barriers that institutional investors have to face when considering active involvement in their investment-companies whether as individual institutions or as a group of institutions. However, a limitation to the above analysis is the fact that with the exception to the shadow director provisions and duties of investment fiduciaries, the legal barriers above involve public issuers of securities. Given the rise of private equity in recent times, there may be a reduction in the influence of the legal barriers on institutional investors' intervention. In other words, the legislative barriers to

⁸⁵ The Laws of New Zealand *Trusts* para 299

<<http://www.lexisnexis.com.helicon.vuw.ac.nz/nz/legal/results/tocBrowseNodeClick.do?tocCSI=274495&rand=0.8429785614738222&clickedNode=TAFSAAKAAC>> (last accessed 16 April 2008).

⁸⁶ The Laws of New Zealand *Trusts* para 296

<<http://www.lexisnexis.com.helicon.vuw.ac.nz/nz/legal/results/tocBrowseNodeClick.do?tocCSI=274495&rand=0.8429785614738222&clickedNode=TAFSAAKAAC>>(last accessed 16 April 2008).

⁸⁷ Farrar, above n 5, 181,

⁸⁸ *Gambotto v WCP Ltd* (1995) 13 ACLC 342

active intervention by institutional investors are heavily dependent on the composition of the institutions' investment portfolio. The next section will discuss the economic issues that tend to discourage institutional investor activism.

B Economic Barriers to Institutional Investor Activism

As outlined above, some commentators have argued that institutions are required to be responsible shareholders to ensure directors act for the benefit of the company as a whole, institutions may perceive their role of shareholder and its entailing duties as merely incidental to its investment strategy. Ali, Stapledon and Gold⁸⁹ in 2003 observed that although there had been a numerous suggestions as to how institutional shareholder might become more active shareholders, the fact was that such suggestions have not been observed in practice. They contend that this “can be explained largely by the economic incentives and disincentives facing institutional investors.”⁹⁰

The most obvious of all economic disincentives costs is the financial cost for institutional investors to intervene in the governance of their investment-companies. Direct costs will include legal and professional advice, employee time charged towards governance issues and consequential loss of opportunity costs arising from using resources on a particular investment-company. For an active institutional investor to commit a number of senior fund managers and upper management of an institution to the monitoring of one investment, must inevitably result in lost businesses elsewhere and a lack of attention to other existing clients.⁹¹ Moreover, if the issue has to be brought before a meeting of the company for vote by the shareholders, active institutional investors would have to bear the cost of circulating lobby documents, proxy solicitation and sacrifice time and effort to argue for their cause at the shareholders' meeting. Given that institutional investors are primarily traders for profit, the cost and time expended on governance matters may not commensurate the benefits received for their effort. Also, given the size of most institutional investor holdings, the institution faces a collective-action problem. Invariably that “in order to be effective, institutional investors activism requires several institutions to participate.”⁹²

⁸⁹ Ali, Stapledon and Gold, above n 83, 15.

⁹⁰ Ali, Stapledon and Gold, above n 83, 15.

⁹¹ Black and Coffee, above n 29, 2059.

⁹² Ali, Stapledon and Gold, above n 83,16.

Related to financial costs of intervention is the complication that arises out of the increasing use of passive funds. Although hailed as an end to the “exit” strategy while encouraging more active and critical actions, institutional investors that actively intervene in the governance of their investment-companies risk affecting the diversity of their indexed portfolio. By devoting more time and financial resources towards particular investments within their indexed portfolio, institutional investors will adversely affect the spread of risk for those passive investments and defeat the purposes of indexing in the first place. Also, if the institutional investor is under-weight for that particular company within its indexed funds, any benefit it generates from intervention and active monitoring would most likely flow to any competitor who over-weighs its investment in that particular company.⁹³ As a result, institutional investors face costs whether the “exit” or “voice” strategy is adopted with regards to passive investments. This argument is supported by survey results showing some index fund managers being highly active while others engage in no activism at all.⁹⁴ Further as the success of certain types of institutional investors, such as fund managers, are usually measured relative to that of its competitors or an index, rather than absolutely, “costly monitoring will only rationally be undertaken in limited circumstances”.⁹⁵

Active monitoring also creates a free-rider effect. If institutional investors’ intervention requires individual incurrence of costs but distributed shared benefits, individual institutional investors are therefore rationally apathetic towards active monitoring given their normal low level of ownership.⁹⁶ Stapledon⁹⁷ refers to this issue as the classic prisoners’ dilemma where although all shareholders will gain if each contributed towards monitoring, no monitoring will occur as it is in the interest of each shareholder not to contribute. As a result, all shareholders are worse off due to their apathy.

In addition, institutional investors incur relational costs by actively monitoring their investment-companies and being critical of the actions of management and directors. One aspect that distinguishes institutional investors from ordinary shareholders is the level of

⁹³ Hendry and others, above n 42, 1113.

⁹⁴ Michael Useem and others “US Institutional Investors Look at Corporate Governance in the 1990’s” (1993) 12 *Journal of Applied Finance*, 8.

⁹⁵ Ali, Stapledon and Gold, above n 83,16.

⁹⁶ See Bainbridge and others, above n 23, 1745

⁹⁷ Stapledon “Disincentives to Activism by Institutional Investors in Listed Australian Companies” (1996) 18 *Sydney L. Rev.* 152, 178.

dependence these investors have on the management of their investment-companies. Institutional investors like financial institutions, insurance companies and unit trusts not only invest funds entrusted to them by their clients but also provide a range of services to other clients. For example, it is not unusual for banks in Japan and Germany to be both the shareholder and debt-holder of loan instruments in any particular company. If institutional investors begin to take active steps in criticising company management on governance issues, institutional investors risk antagonising management which may result in the loss of other services such as advisory or consulting work previously performed by the institution.⁹⁸ The fear of retaliation from management results in a conflict of interest for institutional investors who wish to intervene against managerial decisions.⁹⁹ Empirical results support this notion as pressure-sensitive shareholders like banks and insurance companies cast more proxy votes in favour of management's recommendations compared to pressure-insensitive shareholders like pension funds.¹⁰⁰ Furthermore, incurring relational costs will also result in reputational costs to the institutional investor if it is made known to other clients that the institution is an active intervener on governance matters. Interviews with the institutions' managers refer to this gain in reputation as a loss of valuable business with current and future clients and may affect the personal career of the institutions' managers.¹⁰¹ An example of relational and reputational cost occurred in both the Coles Meyer and Bell Resources cases in Australia. In Coles Meyer, a senior trade-union official intimidated the intervening institution with a withdrawal of its superannuation funds while in the Bell Resources case, the institutional investor was threatened by the offeror-company with negative television publicity if it did not stop complaining about the company.¹⁰² Given the above, institutional investors face issues similar to audit firms before the Enron saga where the prospect of losing other lucrative services may force the institution to take passive steps in the governance of their investment-companies.

Lastly, from a theoretical perspective, although institutional investors have been hailed as the solution to the agency problem due to their size, concentrated ownership and financial resources, an alternative perspective has emerged depicting institutional investors as

⁹⁸ Clearfield, above, n 15, 115; Coffee, above n 29, 1317-1328.

⁹⁹ Gillan and Starks, above n 25, 10.

¹⁰⁰ James Brickley and others "Ownership Structure and Voting on Anti-takeover Amendments" (1988), 20 *Journal of Financial Economics* 267; John Pound "Proxy Contests and the Efficiency of Shareholder Oversight" (1988) 20 *Journal of Financial Economics* 237.

¹⁰¹ Clearfield, above n 15, 115; Stapledon, above n 93, 186.

¹⁰² Stapledon, above n 93, 186.

a cause of greater agency problems. A simplistic view is to perceive the relationship between the institutional investor and its investment-companies as that of a shareholder-management relationship. However, complications arise as institutions are not the “actual” shareholders of the investment-companies. Institutions are only financial intermediaries and the real shareholders are the clients of the institutional investor.¹⁰³ Moreover, the relationship is made even more complex when one takes into account the gap between the institution’s decision makers and its ultimate clients. Within that gap, there are numerous fund managers, brokers, investment consultants, fund trustees and monitoring mechanisms that act to widen the separation between the fund beneficiaries and the institution.¹⁰⁴ With each layer of separation, agency costs for fund contributors increase as more decision-making and control are removed from their influence. Thus, the collectivisation of investment funds contributes more to the agency problem from within the institution itself and between the institution and its investments.¹⁰⁵ Furthermore, agency relationships between the institutional investor and its investment-companies are not merely the typical one-way principal-agent variety. Ryan and Schneider suggest a dual agency relationship where the principal and agent interchange their roles due to the opposing agency contracts entered into between the two parties.¹⁰⁶ An example is that of the insurance company and the insured. The insurance company can be the insurance agent of the insured and concurrently invest funds in the insured’s companies. Although this situation applies directly to all pressure-sensitive institutional investors, pressure-insensitive institutional investors may face these dual-agency contracts in dealing with the government and in supporting the local community.¹⁰⁷ As a result, this complicated relationship may impact the institutional investors’ decision to actively intervene in the governance of their investments given that institutions face a complex web of opposing and reciprocal contracts with their stakeholders.

V CONCLUSION

Institutional investors have an important role to play in corporate governance by being active monitors of their investments and providing another safeguard against management’s plans which may reduce shareholders’ wealth. However, the literature is just beginning to

¹⁰³ Solomon, above n 20, 112.

¹⁰⁴ Solomon, above n 20, 115.

¹⁰⁵ Solomon, above n 20, 112.

¹⁰⁶ Ryan and Schneider, above n17, 406.

¹⁰⁷ Roberto Romano “Public Pension Fund Activism in Corporate Governance Reconsidered” (1993) 93 *Colombia Law Review* 795.

focus on not only whether institutions should intervene, but also whether institutional investors can intervene. Both of these questions need to be debated in order to realistically consider their role in corporate governance. However, although legal impediments can be reduced through the passing of new legislation, the economic impediments are harder to overcome. Institutions are still primarily traders and hold shares as part of their overall investment strategies. As a result, there is a demand for the benefits derived as a shareholder but not the responsibilities it entails. Traders by nature, institutional investors have other business interests to protect and will not sacrifice these profit-making avenues for the sake of good governance. To encourage institutional investors to increase their participation in corporate governance, there is a need for a stronger business case and more robust research into studies that link governance to performance. Doing so would enable corporate governance to become a competitive advantage and bring benefit to institutional investors that do choose to become active monitors.