

OWNERSHIP CONCENTRATION, INSTITUTIONAL INVESTMENT AND CORPORATE GOVERNANCE: AN EMPIRICAL INVESTIGATION OF 100 AUSTRALIAN COMPANIES*

BY IAN M. RAMSAY** AND MARK BLAIR***

[This paper draws together recent developments in legal and economic theory on corporate ownership structure and empirically tests several key theoretical propositions by examining data on 100 Australian companies. The objective is to examine the implications of ownership structure for corporate governance and legal regulation. The two main aspects of ownership structure examined are ownership concentration and institutional investment. The authors evaluate factors which influence ownership concentration and identify the major institutional shareholders in the 100 companies. A number of implications for legal regulation are discussed in the paper including whether different legal rules should apply to companies according to their degree of ownership concentration.]

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** B.A., LL.B. (Hons) (Macq.), LL.M. (Harv.). Associate Dean and Senior Lecturer in Law, University of New South Wales. Solicitor of the Supreme Court of New South Wales. Member of the New York Bar.

*** B.Ec. (Hons), Ph.D. (Syd.). Formerly Deputy Director, Companies and Securities Advisory Committee.

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I. INTRODUCTION

In recent years there has been a resurgence of interest in the ownership structure of companies and other types of firms. In this paper we explore the implications that ownership structure has for corporate governance and legal regulation. As part of our study we conduct an empirical investigation of the ownership structure of 100 Australian companies. We examine factors which influence the ownership structure of these companies and determine the identity of major institutional shareholders.

The analysis begins in Part II with a discussion of why ownership structure is important. One reason is the relationship between ownership structure and agency costs. Examples are provided to illustrate how the choice of ownership structure can be driven by potential agency costs. Part III focuses on one particular aspect of ownership structure — ownership concentration. The literature suggests that, other factors remaining constant, diffuse ownership structures present greater agency costs for shareholders than otherwise is the case. In Part IV we examine the role of institutional investors and the implications that their influence has for corporate governance. Within each of Parts III and IV the structure is as follows.

We first outline the theoretical issues relevant to the debate and the results of prior studies. We then present the results of our own study. We conclude by considering the implications of our research for legal regulation.

II. THE IMPORTANCE OF OWNERSHIP STRUCTURE ANALYSIS

Why is the analysis of ownership structure important? The argument we advance is that the choice of ownership structure by participants in a firm has implications for agency costs. More specifically, firm participants may be able to reduce potential conflicts of interest among themselves by selecting one ownership structure over another. As corporate laws are often framed to reduce such conflicts, the ownership structure of firms can also have implications for legal regulation.

A. OWNERSHIP STRUCTURE AND AGENCY COSTS

The foregoing discussion draws upon the economic theory of agency.¹ We therefore begin with a definition of one of the central notions of the theory — agency costs. Agency costs are those costs that arise because of the divergence of interests between firm participants. In the corporate context, these divergences or conflicts of interest include those between shareholders and managers² as well as those between shareholders and creditors.³ Actions are undertaken to minimise these conflicts of interest. In the case of conflicts between shareholders and managers, shareholders incur monitoring costs in reviewing the actions of managers⁴ while managers incur bonding costs with the aim of assuring shareholders that their interests are being pursued.⁵ Inevitably, some potential for divergences of interest between shareholders and managers will remain. Financial economists label this the ‘residual loss’. Agency costs represent the sum of the residual loss and the monitoring and bonding costs.⁶

It was noted above that different ownership structures have different agency cost implications; one ownership structure may give rise to greater agency costs

¹ Jensen, M.C. and Meckling, W.H., ‘Theory of the Firm: Managerial Behaviour, Agency Costs, and Ownership Structure’ (1976) 3 *Journal of Financial Economics* 305.

² Managers may have a preference for lower effort levels (such as shorter working days) or excessive perquisite consumption (such as excessively high remuneration or fringe benefits). These preferences of managers conflict with those of shareholders (who seek to maximize the value of their shareholdings).

³ Creditors face four main problems resulting from possible actions by shareholders:

- the payment of excessive dividends;
- the incurring of additional debt with similar or higher priority;
- the substitution of non-saleable assets for saleable assets; and
- excessive risk-taking. Shareholders in a leveraged company have incentives to engage in excessive risk-taking. This is because if these investments should prove successful, the excess profits will be distributed among shareholders as dividends and will not be shared with creditors. Company losses, however, will be shared among both shareholders and creditors.

These problems are elaborated in Smith, C.W. and Warner, J.B., ‘On Financial Contracting: An Analysis of Bond Covenants’ (1979) 7 *Journal of Financial Economics* 117. In this paper we are not concerned with conflicts between shareholders and creditors.

⁴ For example, the costs involved in reviewing financial statements and other information distributed by the company to its shareholders.

⁵ Examples of bonding costs incurred by managers include contractual guarantees to have the financial accounts audited, explicit bonding against malfeasance, and contractual limitations on the managers’ decision making powers: Jensen and Meckling, *op. cit.* n.1.

⁶ For further discussion, see Jensen and Meckling, *op. cit.* n.1.

than another. It follows that it may be possible for firm participants to reduce agency costs by selecting a particular ownership structure. Why then do we see a variety of ownership structures, rather than the one 'optimal' structure across all firms? The question can be readily answered once it is recognized that different activities present different agency problems. We contend that the reason why firms in different industries sometimes adopt different ownership structures is because some structures are superior to others for certain purposes.⁷

One situation in which ownership structure — specifically the location of ownership rights — may reduce agency costs is provided in the case of the life insurance industry. This industry has two types of ownership structures: mutual life insurance companies and share capital life insurance companies. Mutual life insurance companies do not have shareholders — instead ownership rights rest with participating policyholders. There is empirical evidence that the choice of ownership structure (mutual versus company) is related to the type of life insurance policy that is issued.⁸ More specifically, mutuals tend to offer those policies that would present the greatest conflicts between policyholders and shareholders. In other words, where potential agency costs between policyholders and shareholders are high, it may be preferable to eliminate shareholders altogether and locate ownership rights with policyholders.⁹

Another example is where managers hold shares in the companies they manage. Managers' share ownership may reduce agency costs between shareholders and managers by ensuring that managers bear a share of the wealth consequences of their actions.¹⁰ Other factors remaining constant, managerial share ownership is expected to be more prevalent in those industries where conflicts of interest between managers and shareholders are pronounced.

⁷ Fama, E.F. and Jensen, M.C., 'Separation of Ownership and Control' (1983) 26 *Journal of Law and Economics* 301; Hansmann, H., 'Ownership of the Firm' (1988) 4 *Journal of Law, Economics, and Organization* 267.

⁸ Blair, M., *Choice of Ownership Structure in the Australian Life Insurance Industry*, Ph.D. Dissertation, University of Sydney, 1991. See also Blair, M. and Ramsay, I., 'Collective Investment Schemes: The Role of the Trustee' (1992) 1 *Australian Accounting Review* (No. 3) 10. Policyholders have the problem of ensuring that funds are available to meet contractual payouts on their policies while shareholders have incentives to dilute policyholders' reserves (for example, by paying excessive dividends) and to undertake risky investment strategies that threaten returns to policyholders.

⁹ Not all life insurance firms are mutuals because the benefit, in agency cost terms, of removing shareholders, needs to be balanced against such factors as the agency costs associated with mutual managers: Mayers, D. and Smith, C.W., 'Contractual Provisions, Organizational Structure, and Conflict Control in Insurance Markets' (1981) 54 *Journal of Business* 407.

¹⁰ Two competing hypotheses arise from the relationship between managers' share ownership and company performance: the convergence of interest hypothesis and the entrenchment hypothesis. The convergence of interest hypothesis predicts that market value and profitability increase with management ownership. This is because the more equity managers hold, the more they bear the costs of any action they undertake that does not maximise the value of the company; Jensen and Meckling, *op. cit.* n.1. The entrenchment hypothesis predicts that market value and profitability do not increase with management ownership. This is because managers, if they hold enough of the shares of their company, will be able to entrench themselves and undertake action that benefits themselves at the expense of the other shareholders: Demsetz, H., 'The Structure of Ownership and the Theory of the Firm' (1983) 26 *Journal of Law and Economics* 375; Morck, R., Shleifer, A. and Vishny, R.W., 'Management Ownership and Market Valuation: An Empirical Analysis' (1988) 20 *Journal of Financial Economics* 293.

For a survey of empirical evidence on the effects of managers' share ownership, see Ramsay, I., 'Directors and Officers' Remuneration: The Role of the Law' forthcoming in [1993] *Journal of Business Law*.

B. OWNERSHIP CONCENTRATION

The examples of the life insurance industry and managers' share ownership provided in the preceding section pertain to the location of ownership rights. Firm ownership structures can also differ in the degree to which ownership is concentrated or diffuse, with further effects on agency costs. Where an ownership structure is concentrated (for example, a company has a few shareholders who each hold a relatively large proportion of issued shares), shareholders have greater incentives to monitor the actions of managers and thereby detect actions which are not in their interests. In other words, concentrated ownership may mean that agency costs are lower than would otherwise be the case. This is explored further in Part III.

C. INSTITUTIONAL INVESTORS

There is international interest in the role of institutional investors.¹¹ Research concerning these investors is a specific instance of a more general interest with ownership structure. As discussed later in this paper, a number of significant issues arise from analysis of institutional investors. The first concerns their role in corporate governance.¹² More specifically, do institutional investors actively monitor the managers of companies in which they invest so that agency costs are reduced?¹³ There is some limited evidence that institutional investors in Australia have become more interventionist with respect to the governance of companies in which they invest.¹⁴ Further evidence for this is the formation in 1990 of the Australian Investment Managers' Group (AIMG) to represent institutional investors.¹⁵ A related issue is the effect of institutional investors on the performance of companies in which they invest. Both of these issues are discussed in Part IV.

D. LEGAL REGULATION

The choice of ownership structure has implications for legal regulation. We noted above that the diffuse share ownership which is typically associated with large public companies can result in higher agency costs than otherwise would be the case. Much of our existing corporate regulation has the objective of aligning the interests of managers and shareholders and thereby reducing agency costs.

¹¹ See, for example, Paefgen, T.C., 'Institutional Investors *Ante Portas*: A Comparative Analysis of an Emergent Force in Corporate America and Germany' (1992) 26 *International Lawyer* 327; the Symposium in (1991) 57 *Brooklyn Law Review* 1 entitled 'Tensions between Institutional Owners and Corporate Managers: An International Perspective' and the Symposium in (1988) 3 *Columbia Business Law Review* 739 entitled 'The American Corporation and the Institutional Investor: Are There Lessons from Abroad?'

¹² For views on this subject, see the Institutional Shareholders' Committee, *The Responsibilities of Institutional Shareholders in the UK* (1991), which argues at page 5 that '[i]nstitutional investors should encourage regular, systematic contact at senior executive level to exchange views and information on strategy, performance, Board membership and quality of management', and the Working Group on Corporate Governance, 'A New Compact for Owners and Directors' (1991) *Harvard Business Review* (July-August) 141.

¹³ See notes 133 to 168 and accompanying text.

¹⁴ Editorial, *Australian Financial Review*, 2 March 1990.

¹⁵ *Australian Financial Review*, 4 October 1990. AIMG had 41 member organisations as at July 1992.

Examples include directors' duties¹⁶ and shareholder litigation.¹⁷ However, we have observed that agency costs can also be reduced by having a more concentrated ownership structure. Consequently, in some circumstances, ownership structure and legal regulation may be viewed as alternative mechanisms for reducing agency costs.

Parts III and IV of this paper document the results of our study and other empirical studies concerning the ownership structures of companies both in Australia and abroad. While consideration of the consequences of ownership structure for legal regulation (for example, the appropriate form of legal regulation for institutional investors) has been undertaken overseas, it is only just beginning in Australia.¹⁸ Differences in ownership structures among countries may be a reason why one form of legal regulation is appropriate in one country but not in others.

III. OWNERSHIP CONCENTRATION

A. THEORETICAL ISSUES

There is an extensive body of research documenting the potential problems that arise when the day-to-day business of companies is delegated by a diffuse group of shareholders to management.¹⁹ It is argued that, because of diffuse ownership, shareholders in modern companies fail to exercise sufficient control over managers, thereby enabling managers to pursue their own ends. The result is that agency costs are likely to be greater than otherwise would be the case.²⁰ This is, in part, because the costs associated with taking action to monitor managers exceed the expected benefits. For a shareholder who wishes to take action, the *expected benefits* of monitoring are lower in a company with diffuse ownership because the shareholder taking the action faces the prospect of other shareholders free-riding on his or her efforts.²¹ In other words, the first shareholder is unable to exclude other shareholders from sharing in the benefits of this action and is unlikely to recoup the expenditures incurred in securing those benefits. The *expected costs* associated with shareholders taking action will be increased in a company with diffuse shareholdings because knowledge of corruption, negligence or inefficiency by management will be more expensive to communicate to a majority of the shareholders than otherwise would be the case.²² In such circumstances, there will be less monitoring of managers by individual shareholders (and higher agency costs) than shareholders would collectively desire.

¹⁶ Bradley, M. and Schipani, C.A., 'The Relevance of the Duty of Care Standard in Corporate Governance' (1989) 75 *Iowa Law Review* 1.

¹⁷ Ramsay, I., 'Corporate Governance, Shareholder Litigation and the Prospects for a Statutory Derivative Action' (1992) 15 *University of New South Wales Law Journal* 149.

¹⁸ See, for example, Australian Law Reform Commission and Companies & Securities Advisory Committee, *Collective Investments: Superannuation* (1992).

¹⁹ The most obvious example is the seminal work of Berle, A. and Means, G., *The Modern Corporation and Private Property* (1932).

²⁰ See notes 1 to 6 and accompanying text.

²¹ 'Free-riding' occurs when individuals benefit from the actions of another without paying a commensurate charge.

²² Alchian, A., 'Corporate Management and Property Rights' in Manne, H. (ed.), *Economic Policy and the Regulation of Corporate Securities* (1969).

Where a shareholder holds a relatively large proportion of a company's shares, that shareholder has a greater incentive than smaller shareholders to monitor managers because he or she will receive a greater share of the benefits that result from detecting mismanagement. It may therefore be hypothesised that, because concentrated share ownership provides greater incentives to monitor management, there will be a positive correlation between the degree of ownership concentration and company performance (other factors remaining stable).²³

On the basis of these arguments, it might be considered that rational action implies concentrated ownership structures. This is not necessarily the case however, as there are a number of countervailing factors.²⁴ First, concentrated shareholdings may not be desirable for individual investors if those shareholdings force the investors to bear risk that would otherwise be diversifiable — in some circumstances, concentrated shareholdings may not even be feasible given the amount of funds that are required.²⁵ Second, there are alternative means of controlling managers. The desirability of concentrated shareholdings will be influenced by the extent to which market forces, such as the market for corporate control and the product market, act as effective disciplinary mechanisms on managers and also by the relative costs and benefits of alternative monitoring mechanisms, such as independent directors. Finally, legal regulation, and the extent to which it reduces agency costs, may reduce the necessity for ownership concentration.

It is important to note that, because of potential conflicts between shareholders, more concentrated share ownership may not increase the value of shares owned by small investors. While large shareholders may be more effective than diffuse shareholders in monitoring management, they may transfer wealth from other shareholders by co-opting the management of the company to engage in these wealth transfers. The vigorous debate in Australia concerning whether partial takeovers should be prohibited involved discussion of whether raiders use partial takeovers to transfer wealth from minority shareholders to themselves following a successful partial takeover.²⁶

B. EMPIRICAL EVIDENCE

In this section we review the results of prior studies that have investigated the consequences of ownership concentration for company performance, leveraged buyouts, management remuneration, and wealth transfers from smaller shareholders to larger shareholders.

²³ Shleifer and Vishny construct a model that demonstrates how large shareholders can increase the profitability of the companies in which they invest: Shleifer, A. and Vishny, R.W., 'Large Shareholders and Corporate Control' (1986) 94 *Journal of Political Economy* 461.

²⁴ Demsetz, H. and Lehn, K., 'The Structure of Corporate Ownership: Causes and Consequences' (1985) 93 *Journal of Political Economy* 1155.

²⁵ This leads Demsetz and Lehn, *ibid.* 1158, to hypothesise an inverse relationship between company size and concentration of ownership.

²⁶ Companies and Securities Law Review Committee, *Report to the Ministerial Council on Partial Takeover Bids* (1985). See also Ramsay, I., 'Balancing Law and Economics: The Case of Partial Takeovers' [1992] *Journal of Business Law* 369.

Company Performance

Results of studies that have endeavoured to ascertain whether there is a relationship between ownership concentration and company performance have had mixed results. An empirical analysis by Demsetz and Lehn of 511 companies operating in major sectors of the US economy, including financial institutions and regulated utilities, did not find any significant relationship between ownership concentration and accounting profit rates. Indeed, the authors state that they did not expect any such relationship.

A decision by shareholders to alter the ownership structure of their firm from concentrated to diffuse should be a decision made in awareness of its consequences for loosening control over professional management. The higher cost and reduced profit that would be associated with this loosening in owner control should be offset by lower capital acquisition cost or other profit-enhancing aspects of diffuse ownership if shareholders choose to broaden ownership.²⁷

Murali and Welch examined the profitability of 43 US publicly-traded companies, each of which had an individual or a small group holding more than 50% of its shares.²⁸ The profitability of these companies did not differ significantly from a sample of 83 publicly-traded companies each of whose shares were widely held. The authors conclude that profitability is not necessarily maximised through the increased ownership concentration resulting from majority ownership. Similar results were obtained by Holderness and Sheehan.²⁹ The authors compared profitability and Tobin's Q³⁰ for 101 US publicly-traded companies, each of which had a shareholder holding more than 50% of its shares, and a similar number of companies, each of whose shares were widely held. No significant difference in either profitability or Tobin's Q was found between the two groups of companies.

Some studies have obtained different results when examining the relationship between ownership concentration and company performance. Hill and Snell investigated data for 122 Fortune 500 companies.³¹ A key finding was that a positive relationship existed between ownership concentration and company productivity (measured as value added per employee, controlling for industry differences). The authors also found a positive relationship between ownership concentration and:

- research and development (R & D) expenditure; and
- related diversification (that is, diversification by a company into a business that is related to its existing business).

With respect to the first point, significant investment in R & D may be in the best interests of shareholders because they benefit from the high return on successful innovations and can reduce the effects of failure by having diverse portfolios.³² With respect to the positive relationship between ownership concentration

²⁷ Demsetz and Lehn, *op. cit.* n.24, 1174.

²⁸ Murali, R. and Welch, J.B., 'Agents, Owners, Control and Performance' (1989) 16 *Journal of Business Finance and Accounting* 385.

²⁹ Holderness, C.G. and Sheehan, D.P., 'The Role of Majority Shareholders in Publicly Held Corporations: An Exploratory Analysis' (1988) 20 *Journal of Financial Economics* 317.

³⁰ Tobin's Q is the ratio of market capitalisation to estimated replacement value of a company's tangible assets. It is used in many studies as a measure of company performance.

³¹ Hill, C.W.L. and Snell, S.A., 'Effects of Ownership Structure and Control on Corporate Productivity' (1989) 32 *Academy of Management Journal* 25.

³² *Ibid.* 31. For a survey of the results of studies demonstrating a statistically significant positive

and related diversification, shareholders have little to gain from unrelated diversification for a number of reasons.³³ First, there is empirical evidence that unrelated diversification is associated with lower economic returns.³⁴ Second, unrelated diversification reduces the resources available for investments that improve returns. Third, shareholders can diversify their own portfolios more quickly and at a lower cost than a company can.

A more recent study of 228 Fortune 500 companies by Belkaoui and Pavlik found support for the hypothesis of a positive relationship between share concentration, at higher ranges of concentration (above 25%), and company performance (as measured by profit and market capitalisation).³⁵ In contrast, the relationship was negative at a low range of share concentration (0-25%). The authors conclude:

These results are consistent with the agency theory view that with a large concentration of stock, stockholders are in a better position to co-ordinate action, demand information that will allow them to overcome information asymmetry, and influence management's actions more towards value maximization.³⁶

The results of these studies demonstrate that increased ownership concentration can, in some circumstances, be a means of increasing profitability while in other circumstances it is not. This is not surprising given that, as we observed earlier, there are a number of alternative means of reducing agency costs other than increasing ownership concentration. If there was uniform evidence of a positive relationship between ownership concentration and company performance, it would be difficult to explain the continued existence of firms with diffuse ownership structures.

Ownership concentration is a dynamic phenomenon that responds to a range of conditions with the result that the optimal ownership structure for a particular company will vary over time.³⁷ Consequently, it is necessary to identify those conditions or circumstances where increased ownership concentration can positively affect performance and those circumstances where alternative means of enhancing performance are best employed. This was the objective of a study by Zeckhauser and Pound.³⁸ The authors identified industries where they believed monitoring of management by shareholders is readily undertaken and those industries where it is difficult.³⁹ The former category included industries such as

relationship between R & D expenditure by companies and the market value of those companies, and a similar relationship between the announcement of R & D expenditure by companies and the share prices of those companies, see Johnson, L.D. and Pazderka, B., 'Firm Value and Investment in R & D' (1993) 14 *Managerial and Decision Economics* 15.

³³ *Ibid.* 29.

³⁴ In addition to the evidence presented by Hill and Snell, a recent study of 103 companies listed on the New Zealand Stock Exchange found that a strategy of related diversification resulted in higher profitability and sales growth: Hamilton, R.T. and Shergill, G.S., 'Extent of Diversification and Company Performance: the New Zealand Evidence' (1993) 14 *Managerial and Decision Economics* 47.

³⁵ Belkaoui, A. and Pavlik, E., 'The Effects of Ownership Structure and Diversification Strategy on Performance' (1992) 13 *Managerial and Decision Economics* 343. Share concentration was calculated as the proportion of ownership by outside shareholders holding more than 5% of the issued shares.

³⁶ *Ibid.* 348.

³⁷ Jaditz, T., 'Monitoring Costs as a Basis for the Dispersion of Firm Ownership' (1992) 13 *Managerial and Decision Economics* 23.

³⁸ Zeckhauser, R.J. and Pound, J., 'Are Large Shareholders Effective Monitors? An Investigation of Share Ownership and Corporate Performance' in Hubbard, R.G. (ed.), *Asymmetric Information, Corporate Finance, and Investment* (1990) 149.

³⁹ The proxy employed for the degree of difficulty of monitoring by shareholders was the ratio of

retailing, textiles and publishing. The latter category included high technology industries such as computers and electronics.

Having categorised industries according to the ease with which management's performance can be monitored by shareholders, the authors then examined the effects of the presence (or absence) of a large shareholder (defined as a single outside shareholder holding more than 15% of the issued shares) in 286 US companies in these industries. In industries where monitoring is readily undertaken, large shareholders were found to be associated with significantly higher expected earnings growth rates. This difference was not present for those companies in industries where monitoring was hypothesised to be difficult, even for a large shareholder. This study supports the view that increased ownership concentration (resulting from the presence of a large shareholder) can lead to a higher level of anticipated future performance, but only where a large shareholder is able to monitor management effectively. Where shareholder monitoring is difficult, alternative ways of improving performance will be utilised.

Leveraged Buyouts

In an influential article published in 1989, Michael Jensen argued that the public company is ill-suited to industries where long-term growth is slow or where internally generated funds exceed opportunities to invest them profitably.⁴⁰ This is because managers in these industries are often able to engage in inefficient investments and tolerate organisational slack. Jensen claims that one response has been leveraged buyouts (LBOs) which reduce agency costs created by conflicts between shareholders and managers by eliminating public shareholders.⁴¹ An LBO can improve efficiency in several ways. Active participation by investors may lead to improved monitoring of management performance. In addition, the increased management ownership and high leverage typically associated with buyouts provide performance incentives for managers.

There is considerable evidence on the enhanced performance of many companies that undergo LBOs. Kaplan studied the post-buyout performance of 58 LBOs completed between 1980 and 1986.⁴² Compared to the pre-buyout period, operating income and cash flow increased significantly over a three year period following the buyout. These improvements remained even when adjustments were made for industry changes. A study by Smith of 58 LBOs supports the findings of Kaplan.⁴³ A detailed analysis of one company undergoing an LBO documented significantly improved performance following the buyout.⁴⁴ The

R & D to sales. The authors hypothesise that the higher the ratio of R & D to sales, the more difficult it is for outside shareholders to monitor the company's likely future performance.

⁴⁰ Jensen, M., 'The Eclipse of the Public Corporation' (1989) *Harvard Business Review* (September-October) 61.

⁴¹ *Ibid.* An LBO is a takeover of a company, sometimes by the management of the company, financed largely by debt.

⁴² Kaplan, S., 'The Effects of Management Buyouts on Operating Performance and Value' (1989) 24 *Journal of Financial Economics* 217.

⁴³ Smith, A.J., 'Corporate Ownership Structure and Performance' (1990) 27 *Journal of Financial Economics* 143.

⁴⁴ Baker, G.P. and Wruck, K.H., 'Organizational Changes and Value Creation in Leveraged Buyouts: The Case of OM Scott & Sons Company' (1989) 25 *Journal of Financial Economics* 163.

studies just cited are all based upon US data. However, there is also evidence from the UK of improved performance for companies which have undergone buyouts.⁴⁵

*Management Remuneration*⁴⁶

Ownership concentration can have consequences for management remuneration. Where shareholders in a company do not have incentives to monitor managers because shareholdings are diffuse, managers may pay themselves excessive remuneration. In other words, there may be a positive correlation between the degree of discretion allowed to managers (more discretion resulting from lower ownership concentration) and the level of their remuneration. This will, of course, be mitigated by market forces acting upon managers such as the product market, the managerial labour market and the market for corporate control, and various contractual monitoring and bonding devices that are put in place by firm participants.

A study by Dyl⁴⁷ tested the hypothesis that excessively high levels of executive remuneration are an important component of agency costs by examining the ownership structure and Chief Executive Officer (CEO) remuneration levels of 271 major US industrial companies. The author found a significant negative relationship between the degree of ownership concentration and CEO remuneration. In other words, CEO remuneration was less for those companies that had more concentrated ownership. The author concludes:

[L]evels of management compensation are related to the degree to which a firm is closely held because major shareholders have a meaningful economic incentive to engage in monitoring activities that reduce the residual loss portion of agency costs.⁴⁸

While the study by Dyl demonstrated a significant relationship between ownership structure and the *level* of remuneration, another study has demonstrated a significant relationship between ownership structure and the *type* of remuneration received by managers.⁴⁹ The authors of this study examined the ownership structure and type of remuneration received by CEOs of 71 large US manufacturing companies. The companies were divided into two categories: shareholder controlled (defined as those companies where at least 5% of the company's issued shares is in the hands of one individual or organization who is not involved in the management of the company) and management controlled (defined as those

⁴⁵ Thompson, R.S., Wright, M. and Robbie, K., 'Management Equity Ownership, Debt and Performance: Some Evidence From UK Management Buyouts' (1992) 39 *Scottish Journal of Political Economy* 413.

⁴⁶ This section is drawn from Ramsay, I., 'Directors and Officers' Remuneration: The Role of the Law' forthcoming in [1993] *Journal of Business Law*.

⁴⁷ Dyl, E.A., 'Corporate Control and Management Compensation: Evidence on the Agency Problem' (1988) 9 *Managerial and Decision Economics* 21.

⁴⁸ *Ibid.* 24. The author observes that agency costs are not just reflected in remuneration. He states that if monitoring activities by major shareholders reduce remuneration levels, presumably they also reduce other residual losses resulting from shirking and excessive consumption of perquisites by managers. A study of the US banking industry has found that concentration of ownership is a means of controlling managerial consumption of perquisites: Brickley, J.A. and James, C.M., 'The Takeover Market, Corporate Board Composition, and Ownership Structure: The Case of Banking' (1987) 30 *Journal of Law and Economics* 161.

⁴⁹ Gomez-Mejia, L.R., Tosi, H. and Hinkin, T., 'Managerial Control, Performance, and Executive Compensation' (1987) 30 *Academy of Management Journal* 51.

companies where no individual or organization controls 5% or more of the issued shares). The authors found that the type of ownership structure of a company is significantly related to the type of remuneration received by its CEO. When a company has a dominant shareholder, bonuses and long-term incentives adopted as part of the remuneration plan ensure that the CEO's remuneration primarily reflects the performance of the company. This is not true for management controlled companies.

Management controlled firms clearly design compensation systems to avoid the vagaries of fluctuating performance and to take advantage of a more stable factor, size. At the same time, executives in management controlled firms, who apparently do take advantage of performance with respect to long-term income, appeared to have the best of both worlds. Their basic salaries were functions of firm size, a relatively stable factor, their long-term incomes were greater when performance was good, and the scale of their organizations provided a downside hedge against poor performance. The managers in owner-controlled firms were in riskier positions — they were primarily rewarded for performance, a more variable and risky factor, in all components of compensation.⁵⁰

The authors conclude that the remuneration plans of management controlled companies 'are not designed well enough to maximize economic efficiency and profitability'.⁵¹

Wealth Transfers From Smaller Shareholders to Larger Shareholders

We observed earlier that while a large shareholder may be more effective than diffuse shareholders in monitoring managers and thereby reducing agency costs, a large shareholder may transfer wealth from other shareholders by co-opting management to engage in these wealth transfers. Rosenstein and Rush analysed share returns for 51 US companies that had a partial owner for at least five years and compared the results with a non partially-owned control group.⁵² Partial ownership was classified as low (5-20%), medium (20-50%) and high (above 50%). The authors found that the low and medium partial-ownership groups significantly underperformed the control group. This was not the case for the high partial-ownership group. The explanation is that there are decreasing marginal benefits in wealth transfers resulting from partial ownership as the percentage of ownership increases. The authors conclude:

Partial ownership appears to have the most deleterious effect on stock returns in companies where a majority interest is not held by the partial holder, perhaps indicating an optimal strategy for partial holders . . . While systematic mismanagement of partially held firms is possible, it implies irrational behaviour. A more plausible explanation is systematic transfer of wealth to partial holders through intercorporate "perquisites" — financial and product market transactions at favorable terms to the partial holder.⁵³

It will be recalled that Holderness and Sheehan found no evidence that shareholders who hold more than 50% of the issued shares of a company use their

⁵⁰ *Ibid.* 65-6.

⁵¹ *Ibid.* 66. This finding was supported in a subsequent study of the practices adopted by the chief compensation officers of 175 companies. The study found that the level of monitoring and alignment of interests of managers and shareholders (by means of incentive remuneration plans) was greater in owner-controlled companies than management-controlled companies: Tosi, H.L. and Gomez-Mejia, L.R., 'The Decoupling of CEO Pay and Performance: An Agency Theory Perspective' (1989) 34 *Administrative Science Quarterly* 169.

⁵² Rosenstein, S. and Rush, D.F., 'The Stock Return Performance of Corporations that are Partially Owned by Other Corporations' (1990) 13 *Journal of Financial Research* 39.

⁵³ *Ibid.* 50.

voting power to exploit minority shareholders. Profitability and Tobin's Q were similar for both majority shareholder companies and diffusely held companies.⁵⁴ Consequently, where wealth transfers from smaller shareholders to larger shareholders do occur, the evidence obtained by Rosenstein and Rush suggests that this will generally be limited to situations where larger shareholders are able to control a company with less than 50% of the issued shares.

Summary

Increased ownership concentration can, in some circumstances, operate to reduce agency costs and improve corporate performance by providing greater incentives for shareholders to monitor management. Several studies referred to in this section demonstrate a positive relationship between ownership concentration and performance. However, as demonstrated by the Zeckhauser and Pound study, increased ownership concentration will not necessarily have this effect where monitoring by shareholders is difficult. In these circumstances, it is likely that other means of reducing agency costs will be employed. There is also evidence drawn from the experience of LBOs that the more concentrated ownership (and other features such as increased management ownership and high leverage) resulting from an LBO can improve corporate performance. However, a partial owner with sufficient influence can engage in wealth transfers from other shareholders and evidence of this occurring where control is exercised with less than 50% of the issued shares was documented.

C. OWNERSHIP CONCENTRATION IN AUSTRALIAN COMPANIES

This section outlines a study we undertook of the ownership concentration of 100 Australian companies. It begins with a brief discussion of previous Australian studies. This is followed by a description of our sample, a discussion of the two principal hypotheses, and our test procedures and results.

Previous Studies

A number of prior studies of the ownership concentration of Australian companies have been undertaken.⁵⁵ A summary of these studies, drawn from Davies,⁵⁶ is set out in Table 1.

Table 1 suggests that the ownership concentration of Australian companies has increased since the 1950s. For example, Wheelwright's 1957 study of the 100 largest Australian companies found that the 20 largest shareholders held, on

⁵⁴ Holderness and Sheehan, *op. cit.* n.29.

⁵⁵ Wheelwright, E.L., *Ownership and Control of Australian Companies* (1957); Wheelwright, E.L. and Miskelly, J., *Anatomy of Australian Manufacturing Industry* (1967); Sykes, T., 'In a Few Hands' *Australian Financial Review* 12-16 February 1973; Lawriwsky, M., *Ownership and Control of Australian Corporations*, Transnational Corporations Research Project, Occasional Paper No. 7, University of Sydney, 1978; Crough, G., 'Small is Beautiful But Disappearing: A Study of Share Ownership in Australia' (1980) *Journal of Australian Political Economy* (No. 8) 3; Davies, P.H., *Equity Finance and the Ownership of Shares*, Australian Financial System Inquiry, Commissioned Studies and Selected Papers, Part 3, 1982.

⁵⁶ Davies, *op. cit.* n.55, 324.

Table 1

<i>Author</i>	<i>Period</i>	<i>Sample</i>	<i>Percent Held By Largest Twenty Shareholders</i>
Wheelwright (1957)	1952-53	100 largest listed companies	37.1
Wheelwright & Miskelly (1967)	1962-64	299 listed and unlisted manufacturing with some mining companies	42.6
Sykes (1973)	1973	Sample of 251 listed companies	47.1
Lawriwsky (1978)	1974	Sample of 226 listed companies	51.7
Crough (1980)	1979	98 largest listed companies	51.2

average, 37.1% of the issued shares. Crough's 1980 study of the 98 largest Australian companies found that the 20 largest shareholders held, on average, 51.2% of the issued shares. However, it should be noted that the studies employed different companies in their samples.

The Sample and Methodology

Our sample contained 100 companies, each of which was included in the All Ordinaries Index of the ASX. The companies were randomly selected from those included in the Index. Thirty eight of the 100 companies were mining companies, while the remainder were classified as industrial companies. Under ASX Listing Rule 3C (3)(e), each listed company must, in its annual report or in a separate statement lodged with the annual report, list the names of the 20 largest holders of each class of equity security and the number of equity securities of each class held. The most recent shareholder concentration report was collected for each sample company. The reporting dates ranged from June 1990 to November 1991. From these reports, the percentage of the ordinary shares held by the top five, ten, and twenty shareholders of each of the sample companies was calculated. Parametric (Student's *t*) and non-parametric (Mann-Whitney) tests were used to examine differences in the variables of concern.⁵⁷

Hypotheses

What factors influence the degree of ownership concentration of Australian companies? The first part of the present study had as its objective the testing of

⁵⁷ The appropriateness of both these tests depends upon the attributes of the population from which the sample companies are drawn. The Student's *t* test assumes normality of the population, while the Mann-Whitney test is appropriate in other circumstances. The degree to which the population sampled for our study approximates normality is unclear. For this reason, both sets of test results have been reported. In most cases the results suggest the same conclusion.

certain hypotheses concerning the determinants of ownership concentration in Australian companies. The two hypotheses are:

- smaller companies have more concentrated ownership structures than larger companies; and
- mining companies have more concentrated ownership structures than industrial companies.

There are two main reasons why we expect smaller companies to have more concentrated ownership structures.⁵⁸ First, the larger the company, the greater is the expenditure required by an individual to hold a given proportion of the company's equity. This higher price of a given proportion of the equity can be expected to reduce ownership concentration. Second, risk aversion may lead to a less concentrated ownership structure. It can be expected that risk averse investors would avoid holding a significant proportion of their wealth in a single asset. Moreover, as Demsetz and Lehn argue:

An attempt to preserve effective and concentrated ownership in the face of larger capital needs requires a small group of owners to commit more wealth to a single enterprise. Normal risk aversion implies that they will purchase additional shares only at lower, risk-compensating prices. This increased cost of capital discourages owners of larger firms from attempting to maintain highly concentrated ownership.⁵⁹

A recent study has compared the ownership concentration and size of United States and Japanese companies.⁶⁰ This study found that the ownership concentration of Japanese companies is significantly higher than that of US companies. The five largest shareholders of 734 Japanese companies held, on average, 33% of the issued shares. The five largest shareholders of 457 US companies held, on average, 25.4% of the issued shares. The average market capitalisation of the Japanese companies was US\$990 million. For the US companies, it was US\$1287.2 million.⁶¹

The second hypothesis is based upon the general proposition that mining companies operate in a less stable environment than industrial companies. This is expected to be the case because of the more speculative nature of the enterprise being undertaken, and the inherent risks associated with being dependent upon commodities prices and international trading. The riskiness of a company's environment is, in turn, expected to influence ownership structure through its effect on managerial discretion.

Where there is stability of prices, technology, market shares and so on managerial behaviour is easily monitored by shareholders; where there is uncertainty management behaviour has a greater impact on performance, in that frequent changes in the environment require frequent adjustments to the deployment of productive assets, and it is correspondingly more difficult for an outsider to monitor. Shareholders have a greater incentive to exercise control in this case and we expect a positive relationship between a measure of risk and ownership control.⁶²

It should be noted that a limitation of our study is that we do not test for the riskiness of the environment in which the sample companies operate.

⁵⁸ For elaboration of some of these reasons, see Leech, D. and Leahy, J., 'Ownership Structure, Control Type Classifications and the Performance of Large British Companies' (1991) 101 *Economic Journal* 1418, 1432; Demsetz and Lehn, *op. cit.* n.24, 1158.

⁵⁹ Demsetz and Lehn, *op. cit.* n.24, 1158.

⁶⁰ Prowse, S.D., 'The Structure of Corporate Ownership in Japan' (1992) 47 *Journal of Finance* 1121.

⁶¹ *Ibid.*

⁶² Leech and Leahy, *op. cit.* n.58, 1433.

Another determinant of ownership concentration, although it is not examined in our study, may be derived from the free cash flow theory of Jensen.⁶³ According to this theory, managers have incentives to make the company grow beyond its optimal size instead of maximising the company's value. Managers do this by investing free cash flow in inefficient investments rather than returning it to shareholders.⁶⁴ Consequently, there will be conflicts of interest between managers and shareholders over payout policies when the company is generating substantial free cash flow. The problem is to motivate managers to pay out cash rather than invest it in projects with negative net present values.⁶⁵ Free cash flow may affect the company's capital structure in two ways. First, Jensen predicts that a company with high levels of free cash flow can be expected to have high leverage since debt creation commits the managers to pay out future cash flow. Second, ownership concentration may be increased in order to provide shareholders with the incentive to actively monitor managers to ensure that they pay out free cash flow.⁶⁶ We do not test whether mining companies would typically have more free cash flow than industrial companies. However, a study of 322 US companies by Garvey did not find any relationship between ownership concentration and free cash flow.⁶⁷

Results

The five largest shareholders of the 100 companies in our sample held, on average, 54% of the issued shares. The 10 largest shareholders held 64% and the 20 largest shareholders held 72%. While our sample cannot be compared directly to those in Table 1, it can be argued that our results support those of Crough who documented increasing ownership concentration of Australian companies since the 1950s.⁶⁸

In order to test the first hypothesis, our sample was divided into the '50 largest' and the '50 smallest' companies.⁶⁹ Size was measured by the market capitalisation of companies in the sample. The results in Table 2 demonstrate that the 50 smallest companies tend to have higher share concentration than the 50 largest companies. For example, the five largest shareholders in the 50 smallest companies held an average of 59.58% of the issued shares. The comparable figure in the 50 largest companies was 47.37%. The Mann-Whitney and Student's t tests suggest that the observed differences are significant at conventional statistical levels. Our results are consistent with results obtained from a number of other

⁶³ Jensen, M.C., 'Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers' (1986) 76 *American Economic Review* 323.

⁶⁴ Free cash flow is defined as cash flow in excess of that required to fund all projects that have positive net present values when discounted at the relevant cost of capital.

⁶⁵ There is evidence from a recent study that companies with high free cash flows have engaged in takeovers which result in only limited benefits: Hanson, R.C., 'Tender Offers and Free Cash Flow: An Empirical Analysis' (1992) 27 *Financial Review* 185.

⁶⁶ Bergstrom, C. and Rydqvist, K., 'The Determinants of Corporate Ownership: An Empirical Study on Swedish Data' (1990) 14 *Journal of Banking and Finance* 237, 239.

⁶⁷ Garvey, G., 'Do Concentrated Shareholdings Mitigate the Agency Problem of "Free Cash Flow"? Some Evidence' (1992) 1 *International Review of Economics and Finance* 347.

⁶⁸ Crough, *op. cit.* n.55.

⁶⁹ This represents the simplest division of the data. It is appropriate on the assumption that the distribution of the data approximates normality.

countries which have found that smaller companies have more concentrated ownership structures than larger companies.⁷⁰

As noted earlier, our sample was comprised of 62 industrial and 38 mining companies. The results for the second hypothesis, which are contained in Table 3, demonstrate that mining companies were, on average, more concentrated than industrial companies. For example, the five largest shareholders in each sample mining company held an average of 61.08% of the issued shares. For shareholders in industrial companies, the comparative figure was 48.82%. The results are consistent when the 10 largest and 20 largest shareholders are examined. The statistical tests that were employed suggest that the observed differences in percentages are significant at conventional statistical levels. It is to be noted that studies using data from other countries have found that ownership concentration increases with the riskiness of the environment in which the company is operating.⁷¹ However, further analysis is required before this reason can be advanced as a determinant of the higher ownership concentration of mining companies in Australia.

Qualifications

Three qualifications apply to the above analysis. The first relates to the presence of bank nominee companies in the 20 largest shareholder lists. Part IVD of this paper documents the identity of institutional investors in our sample of 100 companies. We demonstrate that bank nominee companies are the largest of these investors. Yet bank nominee companies are an aggregation of a range of other investors — most notably superannuation funds but also overseas institutional investors and individual investors. Because of this fragmentation in bank nominee shareholdings, there is an argument that they should be excluded from the 20 largest shareholder lists, with the result that the degree of ownership concentration would be reduced.⁷²

The second qualification that needs to be made relates to a potential multicollinearity problem encountered while conducting the tests. An analysis of Table 4 reveals that the two explanatory variables of interest — industry classification and the size of the sample companies — are related. More specifically, mining companies contained in the sample tended to be smaller than industrial companies — the average size of mining and industrial companies was Aus\$871 million and Aus\$1,146.8 million respectively. Conversely, larger companies tended to be classified as industrial, while smaller companies tended to fall within the mining classification. As a result of this correlation, size may have driven the industry test results and industry classification may have driven the size test results. Both sets of tests were undertaken again in an attempt to control for the intervening factors. The results are contained in Tables 5 to 8. Size and industry classification still appear to have a significant influence on ownership concentration.

⁷⁰ Demsetz and Lehn, *op. cit.* n.24, (US data); Leech and Leahy, *op. cit.* n.58 (UK data); Bergstrom and Rydqvist, *op. cit.* n.66 (Swedish data).

⁷¹ See the studies cited in n.70.

⁷² Davies, *op. cit.* n.55, 341.

To control for industry while testing for a size effect, the industrial and mining sub-samples were examined separately. Consistent with the results reported above, Table 5 suggests that size is an important explanation for the ownership concentration of industrial companies. However, Table 6 suggests that the ownership concentration of mining companies was not affected significantly by size. To control for size while testing for an industry effect, the ten largest industrial companies were removed from the sample. The descriptive statistics of the trimmed sample are reported in Table 7. Of particular note is the reversal in relative sizes: mining companies tend to be larger than industrial companies. While the arbitrariness of this procedure is recognised, it is maintained that, if a size effect is still found to exist for the trimmed sample, it can be asserted with a reasonable amount of confidence that an industry effect exists. The results of the industry analysis are presented in Table 8. They are consistent with the results outlined above and suggest that mining companies have, on average, more concentrated ownership structures than industrial companies.

The third qualification relates to the extent to which share ownership is a useful means of determining control. Important provisions of the Corporations Law are concerned with defining situations where a company is controlled by another company or person. For example, the concept of control is relevant to the definition of subsidiary,⁷³ the regulation of financial benefits to related parties of a public company,⁷⁴ and the requirements concerning consolidated accounts.⁷⁵

In this study we analysed the ownership concentration of 100 companies by examining the holdings of the 20 largest shareholders. Majority share ownership can be a direct means of determining control. Yet share ownership is only a partial means of determining control. One reason is because, as Farrar has demonstrated, control is an 'elusive concept'.⁷⁶ There are differences in the degree of control depending upon whether a shareholder is represented on the board of directors or not. Even a majority shareholder may not be in a position to exercise control if the shareholding is subject to voting restrictions.

Indeed, control can be exercised quite independently of share ownership. For example, Accounting Standards AASB1017 (related party disclosure) and AASB1024 (consolidated accounts) refer to a range of factors, other than share ownership, that may be used to determine control, including whether there is any arrangement, scheme or device which gives a company or entity the capacity to enjoy the benefits and risks of another entity. Interlocking directorships may indicate control independently of share ownership.⁷⁷ Consequently, caution is

⁷³ Section 46 of the Corporations Law provides that a company is a subsidiary of another company if, *inter alia*, the composition of the subsidiary's board of directors is controlled by the other company.

⁷⁴ Corporations Law s.243E.

⁷⁵ Corporations Law s.294B.

⁷⁶ Farrar, J.H., 'Ownership and Control of Listed Public Companies: Revising or Rejecting the Concept of Control' in Pettet, B. (ed.), *Company Law in Change* (1987) 39.

⁷⁷ *Ibid.* 55. There are a number of studies of interlocking directorships of Australian companies: Carroll, R., Stening, B. and Stening, K., 'Interlocking Directorships and the Law in Australia' (1990) 8 *Company and Securities Law Journal* 290; Stening, B.W. and Wai, W.T., 'Interlocking Directorates Among Australia's Largest 250 Corporations 1959-1979' (1984) 20 *Australian and New Zealand Journal of Sociology* 47; Hall, C., 'Interlocking Directorates in Australia: The Significance for Competition Policy' (1983) 55 *The Australian Quarterly* 42.

required when attempting to draw, from studies of share ownership, conclusions concerning the control of companies.⁷⁸

D. IMPLICATIONS FOR LEGAL REGULATION

Policymakers should have an understanding of the relevant empirical evidence when framing regulations for companies and securities markets.⁷⁹ To date, it is not obvious that this always occurs.⁸⁰ What are the implications of the results of our empirical study for legal regulation? In this section we evaluate two possible consequences:

- the greater incentives that shareholders in a company with concentrated shareholdings have to monitor management and inform themselves on corporate matters may allow scope for these shareholders to contract out of some mandatory corporate law rules; and
- the potential for increased inter-investor conflict resulting from concentrated shareholdings may be alleviated by the imposition of controlling shareholders' duties.

Contracting out of Mandatory Corporate Law Rules

Should different legal rules apply to companies according to their degree of ownership concentration? We have noted that both ownership concentration and legal rules have consequences for agency costs. In a company with a high degree of ownership concentration (such as a close corporation⁸¹) shareholders have a greater incentive to monitor managers. This can result in a reduction of agency costs.⁸² Much of corporate law also has the objective of reducing agency costs.⁸³

⁷⁸ Some studies classify companies as either 'management controlled' or 'owner controlled' based upon percentages of share ownership. For example, Dyl, *op. cit.* n.47, defines management-controlled companies as those where no individual or organization controls 5% or more of the issued shares, and owner-controlled companies as those where at least 5% of the issued shares is held by one individual or organization who is not involved in the management of the company. These studies have been criticised because of their classification of companies based upon arbitrary percentages of share ownership: Murali and Welch, *op. cit.* n.28. For further discussion of the problems with these studies see Farrar, *op. cit.* n.76.

⁷⁹ See generally, Daniels, R.J. and MacIntosh, J.G., 'Toward a Distinctive Canadian Corporate Law Regime' (1991) 29 *Osgoode Hall Law Journal* 863.

⁸⁰ For example, it is argued that the legal regulation of companies listed on the Australian Stock Exchange (ASX) does not differentiate among the different markets which constitute the ASX: Headrick, T.E., 'The A to B of Our Two Stock Markets' (1992) *Journal of the Securities Institute of Australia* (No. 1) 2. Although well over 1,000 companies are listed on the ASX, Headrick suggests that the ASX does not operate as one integrated market but as two segmented markets. Nearly half of the market capitalisation resides in just 25 companies (that is, less than 2% of the companies listed on the ASX). Trading is even more concentrated, with 70% of the total trading value being accounted for by 25 companies.

Headrick queries whether there is sufficient difference in the regulation of the two markets given that there is less opportunistic behaviour in the market that comprises the top 25 to 50 companies (what the author terms Market A). In this market, it is the market itself and not legal rules which provide most deterrence because of:

- the higher standards of most of its participants;
- the familiarity of most of the players with each other and the tendency of these 'repeat players' to be careful about impairing relationships by taking advantage of another player; and
- the depth of the market in the shares of companies that comprise Market A.

⁸¹ A close corporation is one that has few shareholders and does not have its shares traded on a public exchange.

⁸² Easterbrook, F.H. and Fischel, D.R., 'Close Corporations and Agency Costs' (1986) 38 *Stanford Law Review* 271.

⁸³ See n.16 and n.17 and accompanying text.

As a general principle, it would seem that participants in close corporations warrant broader freedom to contract than participants in corporations with less concentrated shareholdings. This follows from the fact that not only do shareholders in a close corporation have a greater ability to monitor managers but also, because of their greater incentive to inform themselves on corporate matters, their consent to contracts can be expected to be more meaningful than that of small shareholders in large companies.⁸⁴

This principle has been recognised in a recent law reform proposal relating to contracting out of one aspect of directors' duties. In 1989, the Companies and Securities Law Review Committee in its Report on nominee directors recommended that a director should not be held to breach his or her duty if the director took into account, as a main reason, a consideration other than the benefit of the company as a whole where, *inter alia*:

- all the shareholders have given their consent to the particular exercise of power or performance of duty in that way; or
- the company is being managed in accordance with an agreement to which all shareholders are parties which authorises the director to take into account the interests of one or more of the shareholders in the particular exercise of power or performance of duty.⁸⁵

These prerequisites, which require the agreement of all shareholders, would apply only to those companies which have a high degree of ownership concentration. Despite the recognition by the Committee that such companies should be allowed greater freedom to contract than participants in companies with less concentrated shareholdings, the recommendation has not been enacted.

The conclusion that shareholders in a close corporation warrant broader freedom to contract than shareholders in a public company is qualified. This is because shareholders in a close corporation do not have all of the protections that are available to shareholders in a public company. First, the shares of close corporations are not publicly traded and therefore shareholders cannot readily exit the corporation. Second, there is generally a restriction on the right to transfer shares in a close corporation, and therefore the protection of the market for corporate control will not be available to shareholders.⁸⁶ It has also been asserted that because a shareholder in a close corporation is more likely to have a special-

⁸⁴ The fact that shareholders in a close corporation have a greater incentive and ability to monitor managers has a further implication for corporate law which one of us has explored in another forum. One of the well documented justifications for limited liability is that it decreases the need for shareholders to monitor managers because the financial consequences of company failure are limited. Shareholders may have neither the incentive (particularly if they have only a small shareholding) nor the expertise to monitor the actions of managers. Because limited liability makes shareholder passivity and diversification a more rational strategy, the potential operating costs of companies are reduced. This justification has obvious application to public companies. However, in close corporations, many shareholders are involved in management, making the justification less relevant. This, combined with other considerations, has led a number of commentators to advocate unlimited liability for close corporations. For further discussion, see Ramsay, I., 'The Expansion of Limited Liability: A Comment on Limited Partnerships' forthcoming in (1993) 15 *Sydney Law Review*.

⁸⁵ Companies and Securities Law Review Committee, *Nominee Directors and Alternate Directors* (Report No 8, 1989), para. 65.

⁸⁶ Cheffins, B.R., 'US Close Corporations Legislation: A Model Canada Should Not Follow' (1989) 35 *McGill Law Journal* 160, 163.

ised or firm-specific investment in the enterprise, this increases the risk that other participants may appropriate this investment.⁸⁷

Some of these reasons may explain why the oppression remedy is generally only used in the context of private companies.⁸⁸ When a court allows an oppression action to succeed on the basis that the reasonable expectations of the plaintiff were defeated,⁸⁹ it is acknowledging that although shareholders in small private companies have a greater incentive and ability to reach meaningful bargains than do small shareholders in large public companies, the court is empowered to overturn bargains that result from opportunistic behaviour and that defeat the reasonable expectations of shareholders.

Further research should be directed to determining whether the application of certain corporate law rules to companies should vary according to differences in the ownership concentration of companies.⁹⁰ We note the view of one commentator that the corporate opportunity doctrine (which imposes a duty upon company officers not to usurp a business opportunity that belongs to the company) should apply differently to public companies and private companies. In particular, courts 'should leave more room in the close corporation context for results to turn on special facts, arrangements, and understandings of each situation' because shareholders in these companies are better able to make individual bargains than shareholders in public companies.⁹¹ This recommendation is based upon the argument we noted earlier that shareholders in close corporations have greater incentives to inform themselves because of the concentrated ownership structure of these companies. Even commentators who express reservations about shareholders in close corporations contracting out of fiduciary duties acknowledge that some fiduciary duties do not present problems of possible exploitation and therefore contracting out should be permitted.⁹²

Inter-Investor Conflicts

Our study suggests that Australian companies have a relatively high degree of ownership concentration. The five largest shareholders held, on average, 54% of

⁸⁷ Thompson, R.B., 'The Law's Limits on Contracts in a Corporation' (1990) 15 *Journal of Corporation Law* 377, 393. Thompson notes that if a participant's value to a close corporation is very specialised, the difficulty of transferring this value to another enterprise will expose the participant to the risk of opportunistic behaviour by other participants.

⁸⁸ Ramsay, I., 'Shareholder Litigation: Recent Developments in the Oppression Remedy' (1992) 3 *Newsletter of the Business Law Section of the Law Council of Australia* (no. 4) 6.

⁸⁹ Hill, J., 'Protecting Minority Shareholders and Reasonable Expectations' (1992) 10 *Company and Securities Law Journal* 86.

⁹⁰ For further discussion of the issue of contracting out of mandatory corporate law rules, see Riley, C.A., 'Contracting Out of Company Law: Section 459 of the Companies Act 1985 and the Role of the Courts' (1992) 55 *Modern Law Review* 782; Cheffins, B.R., 'Law, Economics and Morality: Contracting Out of Corporate Law Fiduciary Duties' (1991) 19 *Canadian Business Law Journal* 28.

⁹¹ Clark, R., *Corporate Law* (1986), 238.

⁹² Eisenberg, M.A., 'The Structure of Corporation Law' (1989) 89 *Columbia Law Review* 1461, 1463-70. Eisenberg argues that 'bargains to relax materially the fiduciary rules set by law would likely be systematically underinformed even over the short term. Even if the shareholders understood the content of the rules whose protection they attempted to waive — which is unlikely — they still could not begin to foresee the varying circumstances to which such a waiver would be applicable. Any such waiver would therefore inevitably permit unanticipated opportunistic behaviour': *ibid.* 1469-70. However, Eisenberg observes that some fiduciary rules do not present these problems. For example, 'shareholder approval of a specific conflict-of-interest transaction usually does not present the dangers of systematically underinformed consent and exploitation, because the approval relates to a specific event rather than to an unknown future': *ibid.* 1470.

the issued shares of the companies in which they invested. It was noted in Part III that large shareholders have stronger incentives than small shareholders to monitor managers and thereby reduce agency costs. However, large shareholders are also in a position to exploit minority shareholders. Daniels and MacIntosh have noted that Canadian companies have more concentrated share ownership than US companies. Their conclusion is that conflicts between managers and shareholders are likely to be a less serious problem in Canada than in the United States. At the same time, inter-investor problems are exacerbated.⁹³

Can the same be said for Australia? Clearly, conflicts between managers and shareholders are a significant part of the Australian corporate landscape.⁹⁴ However, some of these conflicts are inter-investor conflicts. This is because managers will sometimes cause companies which they control (directly or indirectly) to invest in public companies which they also manage. They then engage in wealth transfers from minority shareholders in the public companies to those companies which the managers control. Of the 16 priority special investigations undertaken by the Australian Securities Commission, a significant number involve allegations concerning this type of arrangement.⁹⁵

Several Canadian commentators⁹⁶ have argued that the more concentrated share ownership of Canadian companies (compared to US companies), and the assumed increase in inter-investor conflicts that results from this concentration, means that Canadian courts should impose fiduciary duties upon controlling shareholders as

⁹³ Daniels and MacIntosh, *op. cit.* n.79, 887.

⁹⁴ For evidence on the enforcement of directors' duties in Australia, see Tomasic, R., 'Sanctioning Corporate Crime and Misconduct: Beyond Draconian and Decriminalization Solutions' (1992) 2 *Australian Journal of Corporate Law* 82.

⁹⁵ For an outline of the 16 special investigations, see the *Australian Financial Review* 17 April 1991, and Australian Securities Commission, *Report 1991/92* (1992) Ch. 3. Two examples, drawn from judgments, provide illustrations of these types of conflicts.

JN Taylor Holdings (JNT) was a subsidiary of the Bell group of companies. In August 1988, Bond Corporation Holdings (BCH) took over the Bell group and thereby acquired JNT and its subsidiaries. Following the takeover, the directors of JNT resigned and were replaced by four BCH appointees, including Alan Bond. The new directors caused the assets of the JNT group to be sold, and channelled the proceeds, which were in excess of \$200 million, into loans to companies within the Bond group. Loans of \$143 million were made to Bond Corporation Finance, a wholly owned subsidiary of BCH. A loan of \$75 million was made to Dallhold Investments Pty Ltd, the ultimate holding company of Bond Corporation Finance. The loans to Bond Corporation Finance were unsecured and unlikely to be repaid. The loan to Dallhold was secured by a second mortgage over shares in certain companies engaged in a nickel joint venture in Queensland, but the value of that security was doubtful. *Re JN Taylor Holdings Ltd; Zempilas & Ors v. J.N. Taylor Holding Ltd & Ors* (1990) 3 A.C.S.R. 600.

In *Re Spargos Mining NL* (1990) 3 A.C.S.R. 1, the court examined a series of transactions within the Independent Resources Group (IRL) group of companies. These companies had common directors. Spargos had substantial assets at the time of its acquisition by IRL. Consequently, the vast majority of the transactions considered by the court were those whereby funds were channelled out of the company to IRL. For example, in 1988, Spargos provided funds to IRL by acquiring 600,000 preference shares in IRL at a price of \$5 per share. By the time legal action was commenced by a minority shareholder, the shares were worthless. However, the court made the finding that the terms of the investment were such that Spargos' investment in the shares was of no benefit to the company but was designed to assist IRL obtain funds. The shares did not provide any guarantee of regular cash income by way of dividend and the judge stated that, based upon the financial position of IRL when the investment was made, the prospect of any dividends was doubtful. The shares were not redeemable for cash by Spargos but could only be converted to ordinary voting shares in IRL. The court noted that a particular feature was that the shares were only redeemable by IRL and not by Spargos so that Spargos was effectively locked into the investment.

⁹⁶ Daniels and MacIntosh, *op. cit.* n.79; MacIntosh, J.G., Holmes, J. and Thompson, S., 'The Puzzle of Shareholder Fiduciary Duties' (1991) 19 *Canadian Business Law Journal* 86.

occurs in the United States.⁹⁷ Another commentator justifies the imposition of fiduciary duties upon controlling shareholders in the following way:

Generally, the law imposes a fiduciary duty on anyone controlling another's property. As controlling shareholders effectively control the company's and the minority's property, such a general fiduciary duty should apply to controlling shareholders.⁹⁸

Yet we believe that the case for the introduction of controlling shareholder duties in Australia has not been established. The arguments supporting such duties fall into two categories:

- inter-investor conflicts require legal constraints on the behaviour of controlling shareholders;⁹⁹ and
- controlling shareholders control the property of the company and the minority shareholders' investment and this requires the imposition of fiduciary duties.¹⁰⁰

Neither of these arguments is justified in the context of Australia. First, although we have referred to several instances of inter-investor conflicts,¹⁰¹ there is no convincing evidence that the high degree of ownership concentration of Australian companies we have documented is associated with a high degree of inter-investor conflicts. Even if this evidence did exist, it is not clear that the imposition of controlling shareholder duties would alleviate these conflicts, or that existing legal remedies are inadequate. The two examples of inter-investor conflicts referred to above both resulted in successful legal actions by the plaintiffs using existing legal remedies.¹⁰²

Second, there is evidence from a detailed study of 114 US companies with controlling shareholders that these companies did not underperform companies with diffuse shareholders.¹⁰³ No evidence was found that majority shareholders exploit minority shareholders.¹⁰⁴ The study did find that over 90% of controlling shareholders were either directors or officers of their companies.¹⁰⁵ Consequently, these controlling shareholders (or their representatives in the case of controlling shareholders that are companies) are subject to fiduciary duties governing the actions of directors and officers. In these circumstances, it is difficult to see any

⁹⁷ For an outline of the duties of controlling shareholders in the US, see Henn, H.G. and Alexander, J.R., *Laws of Corporations* (3rd ed. 1983) 653-61.

⁹⁸ Cohen, Z., 'Fiduciary Duties of Controlling Shareholders: A Comparative View' (1991) 12 *University of Pennsylvania Journal of International Business Law* 379, 380.

⁹⁹ *Supra* n.96.

¹⁰⁰ *Supra* n.98.

¹⁰¹ *Supra* n.95.

¹⁰² In *Re JN Taylor Holdings Ltd; Zempilas* (1990) 3 A.C.S.R. 600, the plaintiff successfully argued that a provisional liquidator should be appointed to the company because of breaches of directors' duties and oppressive conduct. In *Re Spargos Mining NL* (1990) 3 A.C.S.R. 1 the plaintiff successfully argued for the appointment of a new board of directors based upon the demonstrated oppression of the plaintiff and other shareholders.

¹⁰³ Holderness and Sheehan, *op. cit.* n.29.

¹⁰⁴ *Ibid.* 344-5. We note that because this study is based upon US data and fiduciary duties are imposed upon controlling shareholders in the US, it is possible to argue that the evidence that controlling shareholders do not exploit minority shareholders is itself evidence of the success of these duties. However, the authors do not suggest this as a reason for their findings and instead argue that majority shareholders do not have the incentive to exploit minority shareholders because they typically hold more of the shares (64% on average) than would be rational if their objective was exploitation; *ibid.* 325-6. Moreover, a search of news reports found no instances of lawsuits alleging abuse of corporate powers or exploitation of minority shareholders brought against majority shareholders in any of the 114 companies; *ibid.* 337. Some litigation might be expected if the existence of controlling shareholders resulted in increased inter-investor conflicts.

¹⁰⁵ *Ibid.* 324.

advantages resulting from the imposition of a second layer of fiduciary duties.

Finally, it is necessary for different rights and obligations to be assigned to controlling shareholders depending upon whether they act as shareholders or managers.¹⁰⁶ If controlling shareholders are unnecessarily restricted in their actions (for example, by the imposition of unjustified fiduciary duties) their incentive to improve company performance is reduced. However, when controlling shareholders act as managers they are subject to fiduciary duties (namely directors' and officers' duties) to prevent the exploitation of minority shareholders. To conclude — the high degree of ownership concentration of Australian companies documented in our study does not of itself warrant the imposition of fiduciary duties upon controlling shareholders.

IV. INSTITUTIONAL INVESTMENT

A. EVIDENCE FROM FIVE COUNTRIES ON INCREASING INSTITUTIONAL INVESTMENT

Australia

Table 9 demonstrates that considerable changes in the pattern of share ownership in Australia have occurred over the last 40 years — in particular, institutional investors have increased in importance. A number of studies have documented this trend.¹⁰⁷ Table 10 shows the results of a recent analysis by the Industry Commission of the ownership structure of companies listed on the Australian Stock Exchange (ASX). Australian financial institutions hold 36% of the equity of these companies, while individuals hold only 28%.

In 1991 the ASX conducted a share ownership survey.¹⁰⁸ The survey found that 8.8% of respondents had invested in the share market directly, while a further 1.4% owned shares both directly and also indirectly through managed equity funds. This total of 10.2% was an increase over that identified in previous surveys in 1986 and 1988, which found that 9.2% and 9.0% respectively of those surveyed owned shares directly.¹⁰⁹ This increase in individual share ownership is said to reflect the impact of dividend imputation and the interest among new investors in the partial privatisation of the Commonwealth Bank of Australia.¹¹⁰

What might be the effect of future privatisations in Australia on the relative shareholdings of individuals and institutions? There have been many more privatisations in the United Kingdom than in Australia. It has been said that while privatisations in the United Kingdom have increased the number of individual shareholders, they have not increased the percentage of equities held by individuals, which continues to decline.¹¹¹ The author states that 'the picture in the

¹⁰⁶ The argument in this paragraph is drawn from Barclay, M.J. and Holderness, C.G., 'The Law and Large-Block Trades' (1992) 35 *Journal of Law and Economics* 265, 286-91.

¹⁰⁷ See the studies cited in n.55.

¹⁰⁸ Australian Stock Exchange, *Australian Share Ownership Survey 1991*. The survey was of 3,000 people.

¹⁰⁹ *Ibid.* 3.

¹¹⁰ *Ibid.* The Commonwealth Bank was listed on the ASX on 12 September 1991. Almost 80,000 people, or 29.5% of Commonwealth Bank shareholders, were brought into the share market for the first time through their acquisition of shares in the Bank.

¹¹¹ Davies, P.L., 'Institutional Investors, A UK View' (1991) 57 *Brooklyn Law Review* 129, 131.

United Kingdom continues to be one where equity investment directly by individuals is a relatively shallow activity'.¹¹² The fact that share ownership by Australians is also a shallow activity is demonstrated by the results of the ASX survey. The survey revealed that 39.1% of direct shareholders had only one company in their share portfolio. A total of 52.7% of direct shareholders had only one or two companies in their portfolio.¹¹³ Moreover, 22.2% of direct shareholders had a total share portfolio worth less than \$2,500. A total of 35.3% of direct shareholders had a portfolio worth less than \$5,000.¹¹⁴

United States

The trend to institutional investment is well documented in the United States.¹¹⁵ It has been estimated that 53% of the shares of US public companies were owned by institutional investors in 1990.¹¹⁶ One-third of the 1,000 largest companies had more than 60% institutional ownership.¹¹⁷ Moreover, the 50 largest institutional investors owned 27% of the entire US share market in 1989.¹¹⁸

United Kingdom

Institutional investment is also important in the United Kingdom. A study using 1981 data drawn from the largest UK companies found that the median company had seven financial institutions each owning more than 1% of its shares, amounting to about 11% of the shares in aggregate.¹¹⁹ Institutional investment in the UK has grown significantly over the last 30 years. In 1963, institutional investors held 29.2% of UK listed equities. By 1989, this had grown to 60%.¹²⁰ During the same period, the ownership of listed equities by individuals fell from 53.8% to 20%. The findings of a 1990 survey carried out for the International Stock Exchange in London reveal similarities to the results of the ASX study noted above. The survey found that only 14% of shareholders held shares directly. Moreover, 61% of direct shareholders held only one company in their portfolios. Seventy nine per cent of direct shareholders held only one or two companies in their portfolios.

Japan

In 1984, financial institutions held 43.3% of the issued shares of listed Japanese companies.¹²¹ Of this percentage, commercial banks held 20.5%, insurance com-

¹¹² *Ibid.*

¹¹³ Australian Stock Exchange, *op. cit.* n.108, 21.

¹¹⁴ *Ibid.* 22.

¹¹⁵ Farrar, D.E. and Girton, L., 'Institutional Investors and Concentration of Financial Power: Berle and Means Revisited' (1981) 36 *Journal of Finance* 369.

¹¹⁶ Black, B., 'Agents Watching Agents: The Promise of Institutional Investor Voice' (1992) 39 *University of California Los Angeles Law Review* 811, 827.

¹¹⁷ *Ibid.*

¹¹⁸ Black, B., 'Shareholder Passivity Reexamined' (1990) 89 *Michigan Law Review* 520, 567.

¹¹⁹ Cosh, A.D. and Hughes, A., 'The Anatomy of Corporate Control: Directors, Shareholders and Executive Remuneration in Giant US and UK Corporations' (1987) 11 *Cambridge Journal of Economics* 285, 300.

¹²⁰ Letter from the Secretary General of the UK Institutional Shareholders' Committee dated 23 September 1991, addressed to Ramsay, I. The remaining statistics in this paragraph are taken from this letter.

¹²¹ Prowse, *op. cit.* n.60, 1123.

panies 17.7%, and other financial institutions held the remaining 5.1%. Individuals held 26.7% of the issued shares.¹²² In 1988, financial institutions held 51.2% of the issued shares of listed Japanese companies.¹²³

New Zealand

A study of the ownership structure of 43 New Zealand companies found that between 1962 and 1974, the proportion of equity held by financial institutions in these companies increased from 18% to 33%. During the same period, the proportion of equity held by individuals decreased from 34% to 23%.¹²⁴ A further study of 12 major New Zealand companies for the period 1974 to 1981 (which included only the 20 largest shareholders in each company) found that the number of holdings of individuals decreased from 22% to 7% while the number of holdings of insurance companies increased from 38% to 52%.¹²⁵

Summary

The evidence presented in this section demonstrates increasing institutional investment in each of the five countries surveyed. While it is difficult to draw precise comparisons using the empirical evidence presented above (due to differences in the dates of the various studies and in the classifications they use), it is possible to argue that the degree of institutional investment in Australian companies is somewhat less than for most of the other countries surveyed. Institutional investors hold between 50% and 60% of the issued shares of listed United States, United Kingdom and Japanese companies. For Australia, the figure is only 36%.

B. THEORETICAL ISSUES

The previous section documented the growth in institutional investment. Is this desirable? Some commentators believe that institutional investors can be a powerful force for improving the efficiency of companies.¹²⁶ However, others have levelled a number of criticisms at institutional investors. It has been argued that these investors:

- have demonstrated an unwillingness to monitor adequately the management of companies in which they invest;¹²⁷
- have interests that do not necessarily coincide with the best interests of the company¹²⁸ and may act opportunistically to obtain advantages for themselves to the detriment of less influential shareholders;¹²⁹

¹²² *Ibid.*

¹²³ Prowse, S.D., 'Comments on the Changing Roles of Institutional Investors in the Financial and Governance Markets' in Sametz, A.W. (ed.), *Institutional Investing: Challenges and Responsibilities of the 21st Century* (1991), 50.

¹²⁴ New Zealand Institute of Economic Research, *Equity Investment in New Zealand* (1983), 27.

¹²⁵ *Ibid.*

¹²⁶ Minow, N., 'Shareholders, Stakeholders, and Boards of Directors' (1991) 21 *Stetson Law Review* 197.

¹²⁷ Longstreth, B., 'Takeovers, Corporate Governance, and Stock Ownership: Some Disquieting Trends' (1990) 16 *Journal of Portfolio Management* 54.

¹²⁸ Ferrara, R.C. and Zirlin, H., 'The Institutional Investor and Corporate Ownership' (1992) 19 *Securities Regulation Law Journal* 341.

¹²⁹ Coffee, J.C., 'Liquidity Versus Control: The Institutional Investor As Corporate Monitor' (1991) 91 *Columbia Law Review* 1277, 1329-35.

- have a short term focus that leads companies in which they invest to neglect long term planning and business development;¹³⁰ and
- frequently adopt a policy of index investment that does not benefit the economy.¹³¹

It has also been debated whether institutions have the competence necessary to play an effective role in corporate governance.¹³² Institutional investors themselves have diverging attitudes with respect to their appropriate role in corporate governance.¹³³

Reasons for Passivity

There are a number of reasons why institutional investors may not actively monitor the management of companies in which they invest. It has been argued that institutional investors in the United States have been restricted in their actions by legal regulation.¹³⁴ In particular, the legal system has limited control by financial institutions in that country by prohibiting share ownership for certain institutional investors and forcing the fragmentation of institutional portfolios.¹³⁵ Roe believes that these restrictions have a political explanation, being based upon a pervasive popular mistrust of financial power.¹³⁶

In addition, Coffee has recently argued that there are a number of non-legal reasons for institutional investor passivity.¹³⁷ First, some institutional investors (such as mutual funds whose own investors can withdraw their funds on short notice) need liquidity more than others. For these institutions, exercising control is unacceptable if this means that their investment is no longer liquid. Second, some institutional investors (such as banks) may have a continuing business relationship with a company in which they have invested. The institution may be unwilling to oppose management because of a fear that this would disrupt their business relationship. Third, institutional investors may receive information from the management of companies in which they have invested which is not made

¹³⁰ Vanecko, R.G., 'Regulations 14A and 13D and the Role of Institutional Investors in Corporate Governance' (1992) 87 *Northwestern University Law Review* 376, 409-11.

¹³¹ Lowenstein, L., 'The Effect of Index Investment Policies on Corporate Governance' in Practising Law Institute, *23rd Annual Institute on Securities Regulation*, (Vol. II, 1991).

¹³² Barnard, J.W., 'Institutional Investors and the New Corporate Governance' (1991) 69 *North Carolina Law Review* 1135, 1165-6.

¹³³ Brancato, C.K., 'The Pivotal Role of Institutional Investors in Capital Markets' in Sametz, *op. cit.* n.123, 7.

¹³⁴ Conrad, A.F., 'Beyond Managerialism: Investor Capitalism?' (1988) 22 *University of Michigan Journal of Law Reform* 117, 152-63.

¹³⁵ Roe, M.J., 'Political and Legal Restraints on Ownership and Control of Public Companies' (1990) 27 *Journal of Financial Economics* 7. Other commentators believe that the effect of these legal restrictions has been exaggerated: Vanecko, *op. cit.* n.130.

¹³⁶ *Ibid.* Another commentator expresses this view in the following way:

America seems not to trust her capitalists. For more than half a century state and federal governments have limited investors' influence over the governance of publicly traded corporations. Investors' ability to monitor corporate performance and to control assets that they ultimately own has been subordinated to the interests of other constituencies, most notably corporate management. The persistent theme of this legislative trend is that society cannot trust stockholders and bondholders to promote the 'public interest'. Society is better served, according to this view, if management is sheltered from the discipline that results from active capital-market oversight.

Grundfest, J.A., 'Subordination of American Capital' (1990) 27 *Journal of Financial Economics* 89, 89-90.

¹³⁷ Coffee, *op. cit.* n.129, 1317-28.

available to smaller investors. Opposition to management may see this flow of information stopped.

Another reason that has been cited for why institutional investors may be passive relates to agency cost problems at the institutional investor level. Institutional investors use agents such as money managers, and these money managers have few economic or legal incentives to play an active role in corporate governance.¹³⁸

Increasing Activism

The previous section documented a number of reasons why institutional investors may not actively monitor the management of companies in which they invest. Yet there is some anecdotal evidence of increased activism by institutional investors both overseas¹³⁹ and also in Australia.¹⁴⁰ A possible reason is that the aggregate size of the holdings of institutional investors and the amount invested in a given company might now be so large as to preclude an easy sale of those shares.¹⁴¹ We observed earlier that shareholders who hold a relatively large proportion of a company's shares have greater incentives to monitor managers than smaller shareholders because larger shareholders will receive a greater share of the benefits that result from detecting mismanagement. Consequently, institutional investors may exercise more influence in the companies in which they invest when it is difficult for them to sell their shares.

C. EMPIRICAL EVIDENCE

Some of the important issues arising from the growth of institutional investors are:

- The effect on the capital markets. In particular, what are the effects on the informational efficiency and liquidity of the capital markets and also share prices?
- The effect on the performance of companies in which they invest. Do institutional investors efficiently monitor the managers of these companies or do they remain passive?

These issues, and relevant empirical evidence, are now discussed.

Capital Markets

There is US evidence that the growth of institutional investors has improved the informational efficiency of the capital markets.¹⁴² This evidence suggests that

¹³⁸ Rock, E.B., 'The Logic and (Uncertain) Significance of Institutional Shareholder Activism' (1991) 79 *Georgetown Law Journal* 445.

¹³⁹ See generally Rosenbaum, R.D. and Korens, M.E., 'Trends in Institutional Shareholder Activism: What the Institutions are Doing Today' in Practising Law Institute, *Institutional Investors: Passive Fiduciaries to Activist Owners* (1990). See also Garten, H., 'Institutional Investors and the New Financial Order' (1992) 44 *Rutgers Law Review* 585, 643-9; Part 7 of Sametz, *op. cit.* n.123, concerning institutional investors and proxy contests; and *International Business Week*, 15 March 1993, 38-45, for discussion of international trends concerning institutional investor activism.

¹⁴⁰ See n.14 and n.15 and accompanying text.

¹⁴¹ See Barnard, J.W., *op. cit.* n.132, 1151; Matheson, J.H. and Olson, B.A., 'Corporate Law and the Longterm Shareholder Model of Corporate Governance' (1992) 76 *Minnesota Law Review* 1313.

¹⁴² By informational efficiency, we mean the time it takes for information to be incorporated into share prices.

a higher degree of institutional ownership is associated with more frequent information releases from companies and more intensive research activity by analysts. This results in an inverse relationship between the degree of institutional ownership and variance of share returns.¹⁴³ Recent studies demonstrate that share trading by institutional investors does not (as is sometimes alleged) destabilise share prices,¹⁴⁴ and that shares traded heavily by institutions experience rising turnover, declining volatility, and narrowing bid-ask spreads both in absolute terms and relative to shares with low institutional trading.¹⁴⁵ Hence, institutions appear to have had a positive effect on market liquidity. Moreover, recent evidence concerning share issues supports the argument that the information acquisition activities of institutional investors reduce information asymmetries between managers and the capital markets.¹⁴⁶ The authors state that there may be a number of reasons for this:¹⁴⁷

- institutions typically have greater resources than individual investors to expend on obtaining and analysing corporate information;
- economies of scale and professional expertise give institutions lower marginal costs in acquiring information, as a result of which they can acquire more information of higher quality;
- some institutions (such as insurance companies and banks) may have business relationships with the company that provide them with information that is unavailable to other investors;
- institutions have greater incentives than individual shareholders to monitor the activities of companies because they typically have larger investments; and
- because institutions typically trade more frequently than individual investors, this increases the likelihood of new information being rapidly incorporated into share prices.

Company Behaviour and Performance

The evidence is mixed concerning whether institutional investors have a positive influence on those companies in which they invest. An example of a positive role played by institutional investors can be drawn from Japan. It has been claimed that the fact that Japanese financial institutions take large equity positions in companies to which they lend (which US institutional investors are restricted from doing) may partially explain differences in corporate financial behaviour between the two countries.¹⁴⁸ It is argued that a desire by Japanese financial institutions to lessen the conflicts that otherwise would exist between shareholders and debtholders, and shareholders and managers, leads them to take both large

¹⁴³ Aggarwal, R. and Rao, R.P., 'Institutional Ownership and Distribution of Equity Returns' (1990) 25 *Financial Review* 211.

¹⁴⁴ Lakonishok, J., Shleifer, A. and Vishny, R.W., 'The Impact of Institutional Trading on Stock Prices' (1992) 32 *Journal of Financial Economics* 23.

¹⁴⁵ Jones, J., Lehn, K. and Mulherin, J.H., 'Institutional Ownership of Equity: Effects on Stock Market Liquidity and Corporate Long-Term Investments' in Sametz, *op. cit.* n.123.

¹⁴⁶ Szewczyk, S.H., Tsetsekos, G.P. and Varma, R., 'Institutional Ownership and the Liquidity of Common Stock Offerings' (1992) 27 *Financial Review* 211.

¹⁴⁷ *Ibid.* 214.

¹⁴⁸ Prowse, S.D., 'Institutional Investment Patterns and Corporate Financial Behaviour in the United States and Japan' (1990) 27 *Journal of Financial Economics* 43.

equity and debt positions in companies and actively monitor the managers of these companies.¹⁴⁹

A recent study of takeovers in the United Kingdom compared those acquiring companies that had institutions with substantial shareholdings to those acquiring companies that did not. The objective was to ascertain whether institutional investors use their influence and professional knowledge to discourage mergers which they believe are unlikely to be successful, and encourage those mergers which allocate control to superior management.¹⁵⁰ Prior studies cited by the authors found that, as a general rule, mergers have little impact upon company performance. The authors conclude that 'the increasing share of stock market holdings in the hands of institutional investors does not seem to have altered the basic underlying characteristics of the takeover selection process in the UK'.¹⁵¹ A recent Australian study of 371 listed Australian companies found that institutional investors have little impact on company value (as measured by Tobin's Q) or performance.¹⁵² The author states that 'this finding is inconsistent with . . . efficient monitoring . . . and supports the view that Australian institutions are passive portfolio investors who do not involve themselves in decision making of companies in which they invest'.¹⁵³

Some recent US studies document a positive relationship between the degree of institutional investment and corporate performance. One of these studies¹⁵⁴ found a significant positive relationship between Tobin's Q¹⁵⁵ and the fraction of shares held by institutional investors. The authors conclude that the results are consistent with efficient monitoring of management by these investors. There is also evidence of a positive relationship between the degree of institutional investment and a company's return on equity.¹⁵⁶ Finally, a recent study has documented a positive relationship between the degree of institutional investment and the amount a company spends on research and development.¹⁵⁷ The authors state that their findings contradict the popular claim that the short-sightedness of institu-

¹⁴⁹ *Ibid.* Gilson and Roe argue that the Japanese corporate governance system is motivated not simply by financial institutions seeking a return on capital but also by product market competition. They observe that an empirical observation informs this argument — although financial institutions hold approximately 50% of the issued shares of listed Japanese companies, 25% of the issued shares is held by other corporations, often suppliers or customers: Gilson, R.J. and Roe, M.J., 'Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization' (1993) 102 *Yale Law Journal* 871, 874-5.

¹⁵⁰ Cosh, A.D., Hughes, A., Lee, K. and Singh, A., 'Institutional Investment, Mergers and the Market for Corporate Control' (1989) 7 *International Journal of Industrial Organization* 73.

¹⁵¹ *Ibid.* 97-8. For evidence from the United States that bank acquisitions show positive returns for the bidder only when there are both high levels of share concentration and high levels of insider holdings, see Allen, L. and Cebenoyan, A.S., 'Bank Acquisitions and Ownership Structure: Theory and Evidence' (1991) 15 *Journal of Banking and Finance* 425.

¹⁵² Saywell, R.A., *Ownership Structure and Corporate Valuations: Australian Evidence*, Bachelor of Economics (Honours) Thesis, University of Sydney, 1991. Tobin's Q is defined *supra* n.30.

¹⁵³ *Ibid.* 41.

¹⁵⁴ McConnell, J.J. and Servaes, H., 'Additional Evidence on Equity Ownership and Corporate Value' (1990) 27 *Journal of Financial Economics* 595.

¹⁵⁵ Tobin's Q is defined *supra* n.30.

¹⁵⁶ Chaganti, R. and Damanpour, F., 'Institutional Ownership, Capital Structure, and Firm Performance' (1991) 12 *Strategic Management Journal* 479. However, the study did not find a statistically significant relationship between the degree of institutional investment and return on assets, price-earnings ratio or total share returns.

¹⁵⁷ Baysinger, B.D., Kosnik, R.D. and Turk, T.A., 'Effects of Board and Ownership Structure on Corporate R & D Strategy' (1991) 34 *Academy of Management Journal* 205.

tional investors forces management to adopt a short-term focus when making investment decisions.¹⁵⁸

A number of studies have endeavoured, by analysing shareholder voting, to test the hypothesis that institutional investors efficiently monitor managers of companies in which they invest. A study by Pound¹⁵⁹ of 100 proxy contests in the United States for the period 1981 to 1985 found that the results were more consistent with institutional investors voting with management rather than being efficient monitors. Further studies have examined the extent to which institutional investment is related to the adoption of antitakeover amendments by companies. It has been argued that these amendments decrease the wealth of shareholders (in terms of share returns) by entrenching incumbent managers against the operation of the market for corporate control.¹⁶⁰ The results of these studies are mixed. One study found that institutional investment does not appear to have any substantial impact upon the introduction of antitakeover amendments by a company.¹⁶¹

Yet other studies have found that those antitakeover amendments that have the most harmful effects on the wealth of shareholders are enacted by companies with low levels of institutional shareholdings.¹⁶² It is argued by the authors of other studies that institutional investor opposition is greatest when antitakeover amendment proposals reduce shareholder wealth¹⁶³ and that the evidence shows that institutional investors actively monitor proposed antitakeover amendments and thereby increase the wealth of all shareholders.¹⁶⁴ Agrawal and Mandelker document a positive relationship between the level of ownership by institutional investors and the stock market reaction to the announcement of antitakeover amendments.¹⁶⁵ They conclude that this evidence 'is consistent with the "active investors" hypothesis that postulates that corporations with large institutional ownership are most likely to maximize shareholder wealth'.¹⁶⁶

One reason why the results of the studies are inconclusive is that the effects of antitakeover amendments are ambiguous. As noted above, there is evidence that the enactment of amendments is associated with a decrease in share prices. An obvious explanation is that the market views the enactment of these amendments as a form of management entrenchment that is not in the interests of shareholders. However, a recent study has documented a significant positive relationship between

¹⁵⁸ *Ibid.* 212.

¹⁵⁹ Pound, J., 'Proxy Contests and the Efficiency of Shareholder Oversight' (1988) 20 *Journal of Financial Economics* 237.

¹⁶⁰ Malatesta, P.H. and Walkling, R.A., 'Poison Pill Securities: Stockholder Wealth, Profitability, and Ownership Structure' (1988) 20 *Journal of Financial Economics* 347.

¹⁶¹ Bhagat, S. and Jefferis, R.H., 'Voting Power in the Proxy Process: The Case of Antitakeover Charter Amendments' (1991) 30 *Journal of Financial Economics* 193.

¹⁶² Jarrell, G.A. and Poulsen, A.B., 'Shark Repellents and Stock Prices: The Effects of Antitakeover Amendments Since 1980' (1987) 19 *Journal of Financial Economics* 127.

¹⁶³ Brickley, J.A., Lease, R.C. and Smith, C.W., 'Ownership Structure and Voting on Antitakeover Amendments' (1988) 20 *Journal of Financial Economics* 267.

¹⁶⁴ Agrawal, A. and Mandelker, G.N., 'Large Shareholders and the Monitoring of Managers: The Case of Antitakeover Charter Amendments' (1990) 25 *Journal of Financial and Quantitative Analysis* 143.

¹⁶⁵ Agrawal, A. and Mandelker, G.N., 'Shark Repellents and the Role of Institutional Investors in Corporate Governance' (1992) 13 *Managerial and Decision Economics* 15.

¹⁶⁶ *Ibid.* 21.

the enactment of antitakeover amendments and capital expenditure and expenditure on research and development by these companies.¹⁶⁷ The authors view this evidence as support for the argument that such amendments allow managers to adopt a long-term investment strategy. In the absence of the amendments, the threat of takeovers harms shareholders by forcing managers to forgo profitable long-term investments and concentrate on less profitable short-term projects in order to boost current profits.

What this means is that some antitakeover amendments increase wealth while others reduce wealth. One study was able to separate these amendments by examining the pattern of management share transactions prior to the announcement of their adoption.¹⁶⁸ The evidence indicated that amendments that were preceded by net insider purchases were associated with significant share price increases. The author states that the evidence is consistent with the proposition that managers buy shares in their company if they view the antitakeover amendment as a device that enables the board to extract a greater share of the economic gains from a bidder.

Summary

There is evidence that institutional investment improves the informational efficiency of the capital markets and has a positive effect on market liquidity. However, the evidence is mixed concerning whether there is a positive relationship between institutional investment and company performance, and whether institutional investors are active monitors of the companies in which they invest. Reasons why institutional investors may be passive rather than active monitors were explored in Part IVB.

D. INSTITUTIONAL INVESTMENT IN AUSTRALIAN COMPANIES

The objective of the second part of our empirical study was to identify the extent of institutional investment in our sample of 100 companies. Tables 11, 12 and 13 contain the results of our study.¹⁶⁹ The Tables show that the major investors in our sample are bank nominee companies. For example, National Nominees is one of the five largest shareholders in 53 of the 100 companies. Moreover, it holds between 5% and 10% of the shares in 27 of these companies and over 10% in 9 of the companies. The second most significant bank nominee company is ANZ Nominees. It is one of the five largest shareholders in 46 of the 100 companies. It has between 5% and 10% of the shares in 16 of these companies and over 10% in 15 of the companies. The extent of share ownership by bank nominee companies is revealed by the fact that the bank nominee companies listed in Table 11 are included on 169 occasions in the five largest shareholders of the 100 companies in the sample. On 70 occasions the bank nominee companies

¹⁶⁷ Pugh, W.N., Page, D.E. and Jahera, J.S., 'Antitakeover Charter Amendments: Effects on Corporate Decisions' (1992) 15 *Journal of Financial Research* 57.

¹⁶⁸ Loh, C., 'Poison Pill Securities: Shareholder Wealth and Insider Trading' (1992) 27 *Financial Review* 241.

¹⁶⁹ To be included in the Tables, an investor had to be mentioned as one of the largest five shareholders in the reports of at least two of the sample companies.

hold between 5% and 10% of the shares in the sample companies, and on 29 occasions they hold more than 10% of the shares.

Two reasons have been advanced for why holdings by bank nominee companies have grown substantially:¹⁷⁰

- Increased overseas institutional investment in Australian shares. Investors of this type generally have a resident custodian (such as a bank nominee company) hold their shares and collect dividends.
- The growth of domestic superannuation funds. Many of these use the services of bank nominee companies.

There is an issue as to whether bank nominee companies can be classified as institutional investors. This is because bank nominee companies are an aggregation of a diverse range of individual and institutional investors. At the very least, because these companies may be acting merely as custodians, they need to be distinguished from other investors such as insurance companies.

While there are detailed US studies investigating the beneficial ownership of shares registered in the names of nominees,¹⁷¹ there is less Australian evidence. Davies examined the beneficial ownership of shares registered in the name of bank nominee companies in the BHP share register.¹⁷² He did this by forwarding a questionnaire to the bank nominee companies. While these companies were registered as the holders of 18.1% of BHP shares, they in fact beneficially held only 4.7%. Much of the nominee holding was on behalf of superannuation funds. Davies found that while superannuation funds were registered as the holders of 3.7% of BHP shares, their beneficial ownership was actually 12.9%.¹⁷³

Table 12 documents the share ownership of insurance companies in the sample companies. Not surprisingly, AMP is the leading insurance company investor. It is one of the five largest shareholders in 43 of the 100 companies. It holds between 5% and 10% of the shares in 24 of these companies and over 10% in 10 of the companies. There is a considerable gap between AMP and the second most significant insurance company — National Mutual. A comparison of Tables 11 and 12 reveals that, in aggregate, bank nominee companies have considerably greater share ownership than do insurance companies. Table 13 documents the share ownership of the next highest category of institutional investors — superannuation funds and trustee companies.

An important result of our study concerns the extent to which institutional investors invest in the same companies. Table 14 reveals the number of times the 17 institutional investors referred to in Tables 11, 12 and 13 are represented in the five largest shareholders of the 100 sample companies. Ten of the sample companies do not have any institutional investor representation. Yet in 14 of the companies, all of the five largest shareholders are institutional investors. Furthermore, in 55 of the 100 companies, the institutional investors comprise three or more of the five largest shareholders.

¹⁷⁰ Davies, *op. cit.* n.55, 341.

¹⁷¹ E.g. Subcommittees on Intergovernmental Relations, and Budgeting, Management, and Expenditures of the Committee on Government Operations, United States Senate, *Disclosure of Corporate Ownership* (1974).

¹⁷² Davies, *op. cit.* n.55.

¹⁷³ *Ibid.* Table 6.11, 343.

In order to assess whether there is a correlation between the size of companies (measured by market capitalisation) and the degree of institutional investment, we extracted the 20 largest companies and the 20 smallest companies and examined the degree of institutional investment in each of these samples separately. For the 20 largest companies, the 17 institutional investors referred to in Tables 11, 12 and 13 occupied 83% of the five largest shareholder positions. For the 20 smallest companies, it was only 25%. Saywell, in his study of 371 listed Australian companies, observed increasing institutional investment in larger companies at the expense of smaller companies.¹⁷⁴ Some reasons for this trend are identified by the ASX:

There are logical reasons for institutions to concentrate their investments on the large companies, including relatively lower supervision costs, ease of entry and exit, the attractiveness of franking credits to superannuation funds, trustees' concern about their accountability (including the "prudent man" test on each investment) and public monitoring of the institutions' very short-term investment performance (although they are investing for long-term gain). The Life Insurance Federation of Australia has acknowledged that it is "difficult for many funds or managers to justify the high costs of devoting scarce resources to managing modest amounts of invested funds in small or unlisted companies" because such investments are "very much more demanding and costly" in proportion to the amounts invested than investments in large companies. Furthermore, it frequently takes longer for the gain from investments in smaller companies to be realised, which is incompatible with a striving for short-term performance. These factors are likely to persist, and it is therefore reasonable to expect the two-tier market problem to be aggravated if the institutions' relative investment strength increases.¹⁷⁵

E. IMPLICATIONS FOR LEGAL REGULATION

Institutional investors are increasingly dominating the share registers of Australian companies. It is therefore surprising that there is so little published research on these investors. Despite their importance, we know little about the investment attitudes of institutional investors or their attitudes to their role in corporate governance.¹⁷⁶ A significant issue concerns the implications of the evidence discussed in this paper for legal regulation. This evidence falls into two categories:

- the effect of institutional investors on the capital markets; and
- the effect of institutional investors on the performance of companies in which they invest.

Capital Markets and Mandatory Disclosure

Institutional investors have a number of means of acquiring information independently of any information obtained by reason of mandatory corporate disclosure requirements (such as annual reports and prospectuses).¹⁷⁷ This is recognised in specific provisions of the Corporations Law that provide exemptions from mandatory disclosure requirements where the investor is an institutional investor.

¹⁷⁴ Saywell, *op. cit.* n.152, 36. For the period 1986 to 1989, mean institutional investment ownership in small companies (the author randomly selected 100 of the 500 smallest companies listed on the ASX) decreased from 13.47% to 6.56%. Median ownership declined from 7.43% to 1.83%.

¹⁷⁵ Australian Stock Exchange, 'The Taxation Treatment of Private Equity Investment' (1992) *Companies and Securities Bulletin* (No. 112) 2, 5-6.

¹⁷⁶ For a study of these issues undertaken with respect to US institutional investors, see Conley, J.M. and O'Barr, W.M., 'The Culture of Capital: An Anthropological Investigation of Institutional Investment' (1992) 70 *North Carolina Law Review* 823.

¹⁷⁷ *Supra* n.147 and accompanying text.

For example, where a company is raising capital, a prospectus is not required if the investor is a life insurance company, the trustee of a government superannuation fund, the trustee of any other superannuation fund that has net assets of at least \$10 million, or the manager of an investment fund that has at least \$10 million in assets.¹⁷⁸

The evidence documented in Part IVD concerning the ways in which institutional investors improve the informational efficiency of the capital markets supports these exemptions.¹⁷⁹ The exemptions are also appropriate given the high costs of mandatory disclosure requirements.¹⁸⁰ At the same time, our evidence on the 'two tier' structure of the capital markets impacts upon this conclusion. We documented a positive relationship between the size of companies and the extent to which companies have institutional investors as shareholders. A stronger case for mandatory disclosure requirements can be made for that segment of the capital markets which may be less informationally efficient because of the lower shareholdings of institutional investors in companies constituting that segment.

If institutional investors are instrumental in providing the informational efficiency of the capital markets, this necessitates consideration of whether the current exemptions from the mandatory disclosure requirements should be extended. In other words, is there any merit in maintaining mandatory disclosure requirements for unsophisticated investors if these investors play an insignificant role in providing the informational efficiency of the capital markets?

It has been argued that disclosure documents, such as prospectuses, should be geared to the needs of professional analysts and not unsophisticated investors who tend not to use the information contained in prospectuses.¹⁸¹ Easterbrook and Fischel also argue that mandatory disclosure requirements may not protect unsophisticated investors because as long as informed investors (such as institutional investors) ensure that share prices reflect all publicly available information, unsophisticated investors can free-ride on the work of informed investors by receiving the same price as that received by informed investors.¹⁸²

A recent evaluation of the rationales for mandatory disclosure concludes with the observation that it is difficult to define the extent to which the government should mandate the nature and amount of corporate disclosures.¹⁸³ One possible rationale has particular application to our discussion of institutional investors. It

¹⁷⁸ Corporations Regulations 7.12.05 and 7.12.06. Several of these exemptions have been instrumental in the development of the securitisation industry in Australia: Ramsay, I., 'Financial Innovation and Regulation: The Case of Securitisation' forthcoming in (1993) 4 *Journal of Banking and Finance Law and Practice*.

¹⁷⁹ *Supra* nn.142-7 and accompanying text.

¹⁸⁰ Industry Commission, *Availability of Capital* (1991), Part 9.5.

¹⁸¹ Rodier, A.R., 'Prospectus Disclosure Under the Proposed Securities Act in Ontario : Problems in a Changing Environment' (1985) 23 *University of Western Ontario Law Review* 21.

¹⁸² Easterbrook, F.H. and Fischel, D.R., *The Economic Structure of Corporate Law* (1991) 297-8. Unsophisticated investors may lose when investing in a fraudulent primary issue (i.e. before they receive the protection of trading in the secondary market). However, Easterbrook and Fischel observe that this misconduct can be regulated by a rule prohibiting fraud rather than an expensive rule requiring mandatory disclosure: *ibid.* 298.

¹⁸³ Blair, M., 'The Debate Over Mandatory Corporate Disclosure Rules' (1992) 15 *University of New South Wales Law Journal* 177, 195.

may be that the promotion of corporate governance is a rationale for mandatory disclosure.¹⁸⁴ In other words, disclosure of information may enable reliable monitoring of managers in the interest of shareholders.¹⁸⁵ We observed in Part IVB that there are a number of reasons why institutional investors may not actively monitor the managers of companies in which they invest. If the promotion of corporate governance is a rationale for mandatory disclosure then lack of institutional investor interest in corporate governance may justify disclosure requirements for other investors who do have an interest.

Legal Impediments to Institutional Investor Action

The second part of the empirical evidence concerned the effects of institutional investors on the performance of companies in which they invest. Here, the evidence was mixed. The most recent Australian study was unable to document any significant relationship between the degree of institutional investment in companies and the value or performance of those companies.¹⁸⁶ We noted above that there are a number of possible reasons why institutional investors may remain passive.¹⁸⁷ One such reason was the effect of legal regulations which restrict the actions of institutional investors. We will mention only two which may have this effect for institutional investors holding shares in Australian companies.¹⁸⁸ First, there is a limit on the extent to which banks can hold shares in companies. In particular, any investment by a bank which would constitute more than 12.5% of the equity of a company requires the approval of the Reserve Bank.¹⁸⁹ One means of reducing agency costs between shareholders and creditors is to allow banks to acquire substantial equity holdings in those companies to which they lend. A rule limiting the extent to which banks can hold shares in companies can undercut this. Japanese financial institutions are not constrained by such a rule and Prowse argues that, in taking both large equity and debt positions in the one company, Japanese financial institutions are motivated by a desire to lessen agency conflicts between shareholders and creditors, and shareholders and managers.¹⁹⁰

A second legal restraint operating upon institutional investors is the prudent person rule employed by courts to evaluate whether a trustee has discharged its investment duties properly. The law asks what a reasonably prudent and careful person would have done in like circumstances.¹⁹¹ As part of the prudent person test, courts have traditionally adopted a 'line-by-line' approach and examined the risk and the return for each investment in the scheme without reference to the risk and return of the other investments made by the trustee.¹⁹² This line-by-line

¹⁸⁴ Meier-Schatz, C.J., 'Objectives of Financial Disclosure Regulation' (1986) 8 *Journal of Comparative Business and Capital Market Law* 219, 226-9.

¹⁸⁵ *Ibid.*

¹⁸⁶ Saywell, *op. cit.* n.152.

¹⁸⁷ *Op. cit.* nn. 134-8 and accompanying text.

¹⁸⁸ Further analysis is required with a view to determining whether these legal restrictions actually do restrict the actions of institutional investors. An assessment must also be made of any costs resulting from removing the restrictions.

¹⁸⁹ Reserve Bank of Australia, *Prudential Statement No. G1*.

¹⁹⁰ Prowse, *op. cit.* n.148.

¹⁹¹ Meagher, R.P. and Gummow, W.M.C., *Jacobs' Law of Trusts in Australia* (5th ed. 1986) para. 1718.

¹⁹² Finn, F.J. and Ziegler, P.A., 'Prudence and Fiduciary Obligations in the Investment of Trust Funds' (1987) 61 *Australian Law Journal* 329.

approach is inconsistent with modern portfolio theory which states that the level of portfolio risk depends not only on the risk of the individual assets but also on the degree of correlation between the assets. The prudent person rule:

... discourages trustees (and other fiduciaries) from making many investments now regularly favored by prudent investors including start-up enterprises, venture capital pools, many kinds of real-estate-based investments, foreign stocks, short sales, and options and futures. Some of these investments permit greater diversification across the investment spectrum. Others, such as futures and options, lower the risks from volatile stock prices and interest rates.¹⁹³

In summary, the prudent person rule may lead institutional investors to allocate less of their funds to smaller or riskier companies.¹⁹⁴ Abolition of this rule may therefore have important consequences for the capital markets. In particular, because there is evidence that these investors have a positive effect on the informational efficiency of the capital markets, the removal of legal rules which would encourage institutional investors to increase their holdings in smaller companies may be expected to improve those segments of the capital markets which are relatively inefficient.

We have chosen to discuss only two restrictions imposed upon institutional investors in Australia. Other restrictions include impediments to shareholder communication and voting,¹⁹⁵ and a prohibition on investment companies holding more than 5% of the share capital of any other company.¹⁹⁶ If institutional investors are to be effective monitors of the companies in which they invest, analysis must be given to possible legal impediments to this goal.

V. CONCLUSION

Ownership structure and institutional investment have important implications for corporate governance and legal regulation. Yet discussion of these issues cannot proceed without empirical investigation of ownership structure and the extent of institutional investment. In this paper we have presented the results of our analysis of the ownership structure of 100 Australian companies. We observed that, within our sample, mining companies have more concentrated ownership structures than industrial companies and smaller companies have more concentrated ownership structures than larger companies. A number of possible explanations for these results were discussed. Implications for legal regulation were also explored.

¹⁹³ Gordon, J.N., 'The Puzzling Persistence of the Constrained Prudent Man Rule' (1987) 62 *New York University Law Review* 52, 52-3.

¹⁹⁴ Industry Commission, *op. cit.* n.180, Part 10.3.

¹⁹⁵ *E.g.* under s.252 of the Corporations Law, where 100 shareholders each holding at least \$200 of shares, or shareholders holding at least 5% of the total voting rights of the company, request circulation of a resolution to other shareholders, the company must do so. However, the costs incurred by the company are borne by the requisitioning shareholders unless a majority of all shareholders vote for the company to bear these costs.

Under s.247, shareholders holding at least 5% of the issued share capital are entitled to convene a meeting of shareholders. However, recent judicial interpretations of this section have given it a limited operation, restricting the ability of shareholders to convene a meeting: *LC O'Neil Enterprises Pty Ltd v. Toxic Treatments Ltd* (1986) 10 A.C.L.R. 337; *Vision Nominees Pty Ltd v. Pangea Resources Ltd* (1988) 13 A.C.L.R. 529. For discussion of restrictions on shareholder communication and voting in the United States, see Pound, J., 'Reforming Corporate Governance: Deregulation, Not More Regulation' in Sametz, *op. cit.* n.123.

¹⁹⁶ Corporations Law s.401(2).

The extent of institutional investment in the 100 companies was also documented. We noted in Part IV the debates concerning the appropriate form of regulation for institutional investors and the role of these investors in corporate governance. Before these debates can be resolved, we need to develop an understanding of the extent of institutional investment in Australian companies and the legal environment within which these investors operate. Our research forms part of that process.

Table 2 Size Effects on Shareholder Concentration

	<i>Shareholder concentration</i>		<i>Significance levels*</i>	
	<i>Smallest 50 Companies</i>	<i>Largest 50 Companies</i>	<i>Mann-Whitney</i>	<i>Student's t</i>
<i>Top 5 Shareholders</i>				
Average holdings	59.58%	47.37%	.001	.001
Standard Deviation	18.19	18.45		
<i>Top 10 Shareholders</i>				
Average holdings	69.38%	57.99%	.001	.05
Standard Deviation	17.18	17.75		
<i>Top 20 Shareholders</i>				
Average holdings	76.12%	66.58%	.005	.005
Standard Deviation	15.75	17.08		
Number of sample companies	50	50		

*The figures presented below are two tailed probability values. The size hypothesis is directional. Therefore these values need to be halved.

Table 3 Industry Effects on Shareholder Concentration

	<i>Shareholder concentration</i>		<i>Significance levels*</i>	
	<i>Mining Companies</i>	<i>Industrial Companies</i>	<i>Mann-Whitney</i>	<i>Student's t</i>
<i>Top 5 Shareholders</i>				
Average holdings	61.08%	48.82%	.005	.001
Standard Deviation	16.67	19.33		
<i>Top 10 Shareholders</i>				
Average holdings	71.22%	59.07%	.005	.001
Standard Deviation	14.27	19.05		
<i>Top 20 Shareholders</i>				
Average holdings	78.73%	66.82%	.005	.001
Standard Deviation	12.16	18.07		
Number of sample companies	38	62		

*The figures presented below are two tailed probability values. The industry hypothesis is directional. Therefore these values need to be halved.

Table 4 Size: Descriptive Statistics of the Sample (\$m)

	<i>Mining</i>	<i>Industrial</i>	<i>Combined</i>
Average Size (\$m)	871	1,146.8	1,042.4
Standard Deviation	1,507.9	1,922.9	1,781.6

Table 5 Size Effects on Shareholder Concentration: Industrial Sub-Sample Only

	<i>Shareholder concentration</i>		<i>Significance levels*</i>	
	<i>Smallest 31 Companies</i>	<i>Largest 31 Companies</i>	<i>Mann-Whitney</i>	<i>Student's t</i>
<i>Top 5 Shareholders</i>				
Average holdings	66.12%	41.17%	.003	.001
Standard Deviation	19.16	16.19		
<i>Top 10 Shareholders</i>				
Average holdings	66.12%	52.02%	.002	.002
Standard Deviation	19.16	16.38		
<i>Top 20 Shareholders</i>				
Average holdings	73.03%	60.62%	.002	.001
Standard Deviation	17.75	16.41		
Number of sample companies	31	31		

*The figures presented below are two tailed probability values. The size hypothesis is directional. Therefore these values need to be halved.

Table 6 Size Effects on Shareholder Concentration: Mining Sub-Sample Only

	<i>Shareholder concentration</i>		<i>Significance levels*</i>	
	<i>Smallest 19 Companies</i>	<i>Largest 19 Companies</i>	<i>Mann-Whitney</i>	<i>Student's t</i>
<i>Top 5 Shareholders</i>				
Average holdings	64.68%	57.48%	.1083	.19
Standard Deviation	15.06	17.81		
<i>Top 10 Shareholders</i>				
Average holdings	74.70%	67.73%	.1365	.134
Standard Deviation	11.99	15.78		
<i>Top 20 Shareholders</i>				
Average holdings	81.16%	76.31%	.3069	.22
Standard Deviation	10.34	13.59		
Number of sample companies	19	19		

*The figures presented below are two tailed probability values. The size hypothesis is directional. Therefore these values need to be halved.

Table 7 Size: Descriptive Statistics of the Trimmed Sample (\$m)

	<i>Mining</i> (38 Companies)	<i>Industrial</i> (52 Companies)	<i>Combined</i>
Average Size (\$m)	871	401	600
Standard Deviation	1,507.9	485.3	1,072.4

Table 8 Industry Effects on Shareholder Concentration: Trimmed Sample

	<i>Shareholder concentration</i>		<i>Significance levels*</i>	
	<i>Mining</i> <i>Companies</i>	<i>Industrial</i> <i>Companies</i>	<i>Mann-Whitney</i>	<i>Student's t</i>
<i>Top 5 Shareholders</i>				
Average holdings	61.08%	51.29%	.0193	.016
Standard Deviation	16.67	19.63		
<i>Top 10 Shareholders</i>				
Average holdings	71.22%	61.26%	.0199	.01
Standard Deviation	14.27	19.53		
<i>Top 20 Shareholders</i>				
Average holdings	78.73%	68.74%	.0124	.005
Standard Deviation	12.16	18.64		
Number of sample companies	38	52		

*The figures presented below are two tailed probability values. The industry hypothesis is directional. Therefore these values need to be halved.

Table 9 Net Changes in Holdings of Ordinary and Preference Shares (annual averages — \$m)

<i>Annual average for period</i>	<i>Individual investors</i>	<i>Life offices and private pension funds</i>	<i>Other financial institutions</i>	<i>Overseas investors</i>	<i>Total (net purchases)</i>
1953-1955	137	7	20	57	221
1955-1960	46	35	45	94	220
1960-1965	-5	80	52	153	280
1965-1970	-76	131	99	313	467
1970-1975	26	188	155	159	528
1975-1980	-281	531	367	207	824
1980-1985	-647	1069	1243	1119	2805
1986	-928	3814	3789	2241	8915

Source: Marshman, P. and Davies, P., 'The Role of the Stock Exchange and the Financial Characteristics of Australian Companies' in Bruce, R. *et al.*, *Handbook of Australian Corporate Finance* (4th ed. 1991) 93.

Table 10 Equity Holders in Australian Listed Companies

Australian Financial Institutions	%
Life offices	10
Superannuation funds	22
Investment companies and equity trusts	2
Other	<u>2</u>
Total	36
Other Australian Investors	
Individual	28
Other companies	<u>7</u>
Total	35
Overseas Investors	<u>29</u>
	100

Source: Industry Commission, *Availability of Capital* (Report No. 18, 1991) 140.

Table 11 Bank Nominee Shareholders

<i>Company</i>	<i>No. of times company is listed in the five largest shareholders</i>	<i>No. of times company holds between 5% and 10% of shares</i>	<i>No. of times company holds more than 10% of shares</i>
National Nominees	53	27	9
ANZ Nominees	46	16	15
Bank of NSW Nominees	20	7	2
Chase AMP Nominees	17	4	—
Pendal Nominees (BT)	14	5	—
Citicorp Nominees	9	4	1
CTB Nominees	8	5	2
Westpac Custodian Nominees	<u>2</u>	<u>2</u>	<u>—</u>
	169	70	29

Table 12 Insurance Company Shareholders

<i>Company</i>	<i>No. of times company is listed in the five largest shareholders</i>	<i>No. of times company holds between 5% and 10% of shares</i>	<i>No. of times company holds more than 10% of shares</i>
AMP	43	24	10
National Mutual	15	8	1
NRMA Investments	5	4	—
MLC	5	—	—
Mercantile Mutual	4	1	—
SGIO	<u>2</u>	<u>1</u>	<u>1</u>
	74	38	12

Table 13 Superannuation and Trustee Company Shareholders

<i>Company</i>	<i>No. of times company is listed in the five largest shareholders</i>	<i>No. of times company holds between 5% and 10% of shares</i>	<i>No. of times company holds more than 10% of shares</i>
State Authorities			
Superannuation Board	8	3	—
Perpetual Trustee	8	1	—
Permanent Trustee	<u>4</u>	<u>2</u>	—
	20	6	

Table 14 Representation of Institutional Investors in Five Largest Shareholders

Number of times institutional investors are represented in the five largest shareholders of a company

0	10
1	14
2	21
3	24
4	17
5	<u>14</u>
	100

Note: The institutional investors included in this Table are only those named in Tables 11, 12 and 13.