BOOK REVIEW

INSTITUTIONAL SHAREHOLDERS AND CORPORATE GOVERNANCE

BY GP STAPLEDON

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Clark, in a comment published in 1981,[1] argued that the development of the financial markets and, in particular, the equities market in the United States could be separated into four distinct stages.[2] He described the four stages as:

> The four stages are like generations. They overlap with one another – indeed, none are dead, and all may continue indefinitely – but each in turn had had its own time of rapid and growth. Each stage has its characteristic business entity and set of roles, and there is a clear overall trend to the changes between the stages. The first stage is the age of entrepreneur, the fabled promoter-investor-manager who launched large-scale business organisations in corporate form for the first time ... He was primarily a nineteenth century phenomenon.
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> The second stage, which reached adulthood in the first few decades of the twentieth century, is the age of the professional manager. He appeared when the entrepreneurial function was split into ownership and control, a development heralded in 1932 by Berle and Means...The characteristic institution of the age was the modern publicly held corporation. The second stage required the legal system to develop stable relationships between professional managers and public investors, ostensibly aimed at keeping the former accountable to the latter, but also placing full control of business decisions in the managers' hands. A major legal correlate was the enactment of the federal securities laws during the Depression...
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> The third stage of capitalism has been growing since the beginning of this century, and probably reached young adulthood in the 1960's. It is the age of the portfolio manager, and its characteristic institution is the institutional investor, or financial intermediary. As the second stage split entrepreneurship into ownership and control, and professionalized the latter, so the third stage split ownership into capital supplying and investment, and professionalized the investment function...
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> The increasing separation of the decision about how to invest from the decision to supply capital for investment is one of the most striking institutional developments in our century. Since 1900, the proportion of savings channelled through financial intermediaries has grown steadily, and about eighty cents of every dollar saved now

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1 Clark, RC "The Four Stages of Capitalism: Reflections on Investment Management Treatises" (1981) 94 Harvard Law Review 561.

2 Ibid, 562.

> finds its way to some intermediary...
> Can the fourth stage be predicted? It can, for it is already discernible in its infancy. One fumbles for an apt label, but perhaps it could be called the age of the savings planner. Just as the third stage split the capital ownership function into the decision to supply capital funds and active investment management, and professionalized the latter, so the fourth stage seems intent upon splitting capital supplying into the possession of beneficial claims and the decision to save, and professionalizing the savings-decision function. [3]

Clark summarised the underlying processes:

> ...each shift from one stage to the next is marked by two features: increased division of labor, and increased participation in the fruits of capitalist enterprise.
> But this sharing...of the benefits of capitalist enterprise has been accompanied by an ever greater concentration of important discretionary powers in the hands of professional managers and group representatives. [4]

Since Clark wrote his commentary legal scholarship has explored the possible role of institutional investors in the corporate governance of listed companies. For example, Baums, Buxbaum and Hopt (eds), in their 1994 book *Institutional Investors and Corporate Governance*, MacIntosh,[5] and Black.[6]

It is in the context of Clark's third and fourth stages, and the importance of institutional investors for, not only investment decisions, but also for the appropriate governance of companies that Stapledon's new book makes a contribution. The book has two approaches:

> [The first is] partly a positive approach, in that it aims to increase the state of knowledge about the extent and mechanics of institutional monitoring in the UK and Australia, and about how institutional monitoring interacts with other elements of the monitoring environment. It also has a normative aspect, in that it seeks to identify ways in which one part of the internal control system–monitoring by institutional shareholders could be improved. [7]

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3 Ibid, 562-565.

4 Ibid, 567-568.

5 MacIntosh, J "The Role of Institutional and Retail Investors in Canadian Capital Markets" (1993) Osgoode Hall LJ 371.

6 Black, B "The Value of Institutional Investor Monitoring: The Empirical Evidence" (1992) 39 UCLA Law Review 895.

7 *Institutional Shareholders and Corporate Governance* (1996), 18.

Stapledon examined the role of institutional shareholders in corporate governance in the United Kingdom and Australia. While there has been some writing on this area in Australasia,[8] *Institutional Shareholders and Corporate Governance* makes a significant contribution to this area because it contains, not only an extensive overview of the theory and evidence on institutional investors from an international perspective, but also because it is based on extensive interviews with managers and senior officials of institutional investors.

Stapledon compared and contrasted the UK and Australian systems of corporate governance. In his introductory chapter he covers the basic issues of power structure in large corporations (such as the organisation of the board and the general meeting),[9] and the crucial issue of agency costs (which are the costs incurred by shareholders in monitoring management of a company).[10] He further sets the stage for a consideration of the role of institutional shareholders by examining the mechanisms which operate or are supposed to operate as means of monitoring managers. As he points out, these mechanisms have their limitations, but he also notes that institutional investors have already started to play a significant role in this area.[11] In his second chapter he provides details as to the growth of institutional investors as investors in the equity markets of Australia and the United Kingdom.

Parts II and III of the book then deal with the substantive parts of the topic. One of the significant contributions made by this book is the information and analysis provided by interviews that were undertaken by Stapledon with the chief executive or a senior fund manager with 17 UK investment-management firms,[12] and 13 Australian investment-management firms.[13] Unlike previous studies which have relied primarily upon publicly available information,[14] interviews with actual decision

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8 Ramsay, I and Blair, M "Ownership Concentration, Institutional Investment and Corporate Governance: An Empirical Investigation of 100 Australian Companies" (1993) 19 MULR 153, and Walker, G and Fox, M "Institutional Investment in New Zealand Publicly Listed Companies" (1994) 12 C&SLJ 470.

9 Stapledon, supra note 7, 6.

10 Ibid, 7.

11 Ibid, 17-18.

12 Ibid, 55.

13 Ibid, 167.

14 For example Hill, J and Ramsay, I, "Institutional Investment in Australia: Theory and Evidence" in Walker, G and Fisse, B, *Securities Regulation in Australia and New* Zealand, (1994).

makers inside institutional investment firms enables a greater insight into the perceptions of institutional investors as to their roles in corporate governance, the influence of the respective corporate laws, and stock exchange rules.

In dealing with both the UK and Australian position Stapledon deals with the corporate governance issues that institutional investors have been concerned with, such as pre-emption rights, non-voting shares, buybacks, and management by-outs.[15] He then goes on to deal with the manner in which institutional investors become involved in these various issues.[16] In addition, due to the availability of information, he was able to examine the institutional shareholder profile of UK listed companies for large, medium and small companies. The importance of this examination is that it shows the possibility of a small group of institutions challenging the management of a listed company. Not surprisingly he found that it was only in small companies and (to a lesser extent) medium sized companies that an ideal coalition could be formed. This is important because an individual institutional investor would rarely possess a controlling stake in a corporation and, in order to successfully oppose an action proposed by management, such investors would need to act collectively.

In Part IV Stapledon then moves onto the normative part of his book. He examines the desirability of increased institutional monitoring and deals with a number of arguments raised against institutional shareholding.[17] He then examines the potential for increased institutional monitoring, both in the context of the current regulatory regime,[18] and with reforms.[19] The reforms he suggests covers two areas – direct monitoring (where he discusses such reforms as compulsory voting, increased notice of general meetings, etc),[20] and indirect monitoring (through reforms such as board composition and structure, and institutional non-executive directors).[21]

What then is the relevance of this book for the New Zealand's capital market? The answer is that this book is highly relevant for three reasons: the structure of the new Zealand stock market; the regulatory structure for corporations in New Zealand; and the sharing of institutional investors with overseas countries, particularly Australia.

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15 Stapledon, supra note 7, chapters 4 and 7.

16 Ibid, chapters 5 and 8.

17 Ibid, chapter 9.

18 Ibid, chapter 10.

19 Ibid, chapter 11.

20 Ibid, 285-291.

21 Ibid, 291-295.

In the first place, New Zealand's stockmarket structure bears significant similarities with that of Australia, and to a lesser extent the United Kingdom. While we have seen the rise of the fourth stage to a certain extent (with the lack of a compulsory superannuation scheme in New Zealand perhaps holding back the development of the fourth stage in the New Zealand context) Clark's third stage is very much in evidence in New Zealand.

Walker and Fox undertook research into the composition of share ownership in New Zealand.[22] They found:

> ...over the period from 1962 to 1993, there has been a significant shift to majority control among New Zealand listed companies. By 1993, 50% of our listed companies were majority controlled. This increase in majority controlled companies has taken place along with a decline in the proportion of our companies that are management controlled. Fogelberg's 1980 study found that 39.5 per cent of the 43 largest companies in the year 1962 were management controlled. In contrast, by 1993 only 2.6% of all listed companies were management controlled. A significant increase in the proportion of minority controlled companies is also evident over the 1992 to 1993 period, as is a significant decrease in the proportion of listed companies having joint control.
> From the preceding analysis, we conclude that there is little evidence of a "managerial revolution" in terms of the control of New Zealand listed companies. In fact, the reverse is the case, with companies coming increasingly under the control of major shareholders.[23]

They also found foreign direct investment "ha[d] increased from $8.4 billion in 1988 to $26.5 billion in 1994, an increase of some 215 percent".[24] This rise impacted on the level of control exercised by foreign investors, with foreign minority control rising from 8.7 percent of listed companies to 23.1 percent (in 1990) and to 29.2 percent (in 1994).[25] During the

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22 Fox, M and Walker, G "Evidence on the Corporate Governance of New Zealand Listed Companies" (1995) 8 Otago Law Review 317. They used a classification for different control types in companies devised by Fogelberg (Fogelberg, "Ownership and Control in 43 of New Zealand's Largest Companies" (1980) 2 New Zealand Journal of Business 54). He classified control into four types: (1) majority (where one holder or a tightly knit group holds more than 50% of the shares); (2) minority (where an individual or small cohesive group of holders control between 15 to 50% of the share capital and can dominate the company); (3) joint (where a minority interest is strengthened by association with management); and (4) management (where ownership is so widely distributed that no one individual or group has a minority interest large enough to allow them to dominate the company's affairs). Fox & Walker, ibid, 320.

23 Ibid, 323.

24 Idem.

25 Ibid, 325.

period 1990 to 1993 the percentage of companies under majority control (foreign or domestic) rose from 28.8 percent to 53.4 percent.[26] This meant approximately 82.6 percent of the New Zealand listed companies were under absolute or effective control.

When the share ownership structure of the New Zealand Stock Exchange Top 40 Companies was examined the predominance of institutional and foreign investors was even more acute. Walker and Fox found the following:

> Between 1989 and 1993 there was an increase in average overseas investment from 19 percent *per company* to 43 per cent;
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> From 1989 to 1996 total institutional investment rose from 26 percent to 42 percent;
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> Local institutions declined in investment from 16 percent in 1989 to 11 percent in 1996;
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> Overseas institutions increased their investment over the period 1989 to 1996 from 10 percent to 32 percent;
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> Overseas corporate investment increased between 1993 and 1996 from 16 percent to 26 percent;
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> Local corporate investors reduced their holdings from 21 percent in 1989 to 7 percent in 1993.[27]

Walker and Fox's latest research shows a continuation of this trend,[28] and that the New Zealand stockmarket has progressed past Clark's second stage and is well within the third stage. Accordingly, New Zealand's stockmarket shares a similar pattern with Australia.

The second reason for the relevance of this book relates to the regulatory structure for corporations. Unlike Australia, which relies upon the presence of a strong regulatory agency,[29] corporate governance in New Zealand's

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26 Idem.

27 Ibid, 326. Some of the figures for the period 1993 to 1996 are updated from their more recent note, infra n.28.

28 Walker, G & Fox, M "Further Evidence on the Ownership of New Zealand Stock Exchange Top 40 Companies" (1996) 14 Companies and Securities Law Journal (forthcoming).

29 Fitzsimons, P "Disharmony across the Tasman: Australia and New Zealand on Different Corporate Paths" (1994) 8 Otago Law Review 267, 283.

corporate law model is shareholder driven, with little power and scope for regulatory agencies to take action and protect the interests of shareholders.[30] This position is emphasised by the inclusion in the Companies Act 1993 of new shareholders' rights and remedies.[31] However, an individual shareholder faces significant information, expertise and cost disadvantages that make the likelihood of actions by individual shareholders difficult and unlikely.[32] Given this vacuum the actions of institutional investors, who have the expertise and better access to information than the individual investor, are very important in the New Zealand context for companies listed on the stockmarket. Accordingly, the views and approaches of institutional investors in necessary in order to understand the regulatory environment actually faced by directors, and the appropriateness of the current regulatory structure. As Walker and Fox noted:

> At present there is no direct relationship between the ownership composition of the New Zealand sharemarket and securities regulation. We cannot say, for example, that the New Zealand securities regime currently reflects the dominance of institutional investors. We do know that it is based on traditional goals of investors protection and to this extent the regime indirectly reflects the interests of all owners. Those goals were initially formulated in England in the mid-nineteenth century for the protection of *individual* investors who were then the principal owners of the sharemarkets.[33]

The third reason for the significance of the book is further highlighted by the fact that a large number of the institutional investors are subsidiary or associated companies of Australian institutional investors. An insight into the approaches of Australian institutional investors should provide some insights into possible approaches of New Zealand institutional investors as this association should impact upon their internal policies, and approaches to corporate governance issues. While the Companies Act 1993 makes a number of changes to comparable rules in Australia (such as the requirement that "major transactions have shareholder approval (section 129), and allow a dissenting shareholder to require the company to buy out his or her shares (section 106(b)), the underlying principles and composition of the share registers of listed companies of Australia are

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30 Ibid, 285.

31 Idem.

32 See Fitzsimons, P "Statutory Derivative Actions in New Zealand" (1996) 14(3) Companies and Securities Law Journal 184.

33 Fox, M and Walker, G "Market Ownership and Control - Implications for Securities Regulation in New Zealand" in *Securities Regulation in Australia and New Zealand* 2 ed, (Oxford University Press, 1997, forthcoming).

sufficiently similar to mean that this book provides valuable insights into this aspect of the capital markets and institutional investor behaviour.

The relevance of institutional investors for stockmarkets in general, and for New Zealand in particular, will grow. As this book provides invaluable insights into institutional investor behaviour in the context of corporate governance it is highly recommended.

PETER FITZSIMONS*

* BCom, LLB (UNSW) MCL (Hons)(Auck), Senior Lecturer in Law, University of Waikato.