Institutional Investors & Investment Managers’ Involvement in Corporate Governance in the UK:

Are they Able & Willing to Hold Corporate Managers to Account?

Thesis submitted for the degree of Doctorate of Philosophy at the University of Leicester

by

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Abstract
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It was stated by the Cadbury Committee (1992) that: ‘[t]he basic system of governance in Britain is sound. The principles are well known and widely followed.’ This thesis argues that such a statement is in fact exaggerated as far as public listed companies are concerned. Despite the fact that changes have occurred in the share ownership structure of U.K. public listed companies, leading to the concentration of share ownership in the hands of institutional investors and investment managers, the economic and legal framework of the market still fails to support them, as the market’s main financial players, in holding corporate managers to account, and hence achieving a sound corporate governance system. The objective of this thesis was to examine the economic and legal frameworks of the present corporate governance system and its influence on institutional investors and investment managers with regards to their role in holding corporate managers to account. In doing so, the thesis went through three phases.

In the first phase, the thesis introduces the U.K. corporate governance model, concluding that it relies almost solely on shareholders in holding corporate managers to account. The fact that institutional investors and investment managers hold the majority of shares in U.K. public listed companies makes them the obvious candidates to play such a role. Yet, the economic framework of the market does not particularly motivate institutional investors and investment managers to do so. Whilst some institutional investors and investment managers may still be undeterred by this, the question posed was; does then, the market’s legal framework, offer such institutional investors and investment managers the support to hold corporate managers to account?

In light of this question, the second phase of this thesis examined whether contract negotiation, litigation and the use of proxies and voting are viable means available to shareholders in holding corporate managers to account. Contract negotiation and litigation were found to fall short of doing so, whilst the voting and proxy system, although not widely used by institutional shareholders and investment managers, might in the future, hold part of the answer. If institutional investors and investment managers are still undeterred by the economic and legal obstacles, they may resort to dialogue among themselves and with investment managers, as a means to holding corporate managers accountable. Yet, as exemplified in the third phase of this thesis, shareholders are over regulated when it comes to both dialogue amongst themselves as well as with corporate managers, leaving it to the extreme will and determination of shareholders to take initiatives in attempting to hold corporate manager to account; something that many institutional investors and investment managers may in fact, lack.
ACKNOWLEDGMENT

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Part One
Chapter One

Introduction

1.1. Thesis Hypothesis

This thesis argues that a fundamental problem exists in applying the current company law framework to large modern corporations. This may be due to the resistance of the U.K.'s legislature in the last century, to accommodate for a different type of governance for large corporations to other companies. As time has passed, it has become even more difficult to change the system. Instead, the legislature is constantly introducing amendments to the legal framework of corporations. Moreover, the U.K. Government and the financial market constantly introduce supporting codes of self-regulations to support the existing regulatory framework. Hence, the issue of whether corporate managers should be accountable to stakeholders, rather than shareholders, is a question of the past. Most certainly, the current legal framework cannot accommodate for the accountability of corporate managers to stakeholders groups other than shareholders. In fact, calling for such a method of accountability within the existing legal framework is like calling for corporate managers to be accountable to none.

Although directors’ fiduciary duties and the duty of skill and care have been developed through judicial decisions, courts in the U.K. are still reluctant to interfere with the machinations of management and the ‘business judgement rule’. Courts are also reluctant to allow shareholders to use derivative action to sue on behalf of listed companies. Moreover, shareholders in large corporations, holding small parcels of shares, normally lack the ability to monitor and control corporate managers. All this has created near insuperable barriers to successful action in challenging the stewardship of management. Yet, the growth of institutional shareholders’ ownership in both the U.K. and the U.S.A. has brought a glimmer of hope for change. Some legal scholars have already claimed that institutional shareholders are monitoring and holding corporate managers accountable in the U.K.
The central idea of this thesis is that institutional investors are supposed to hold the key to accountability of governance in U.K. listed companies, but that the legal and economic frameworks in which U.K. companies work, makes it unrealistic to exercise their power effectively. Although this thesis acknowledges that there are some examples of institutional shareholders’ activism, the situation is still very short of one claiming that there an effective system to hold management accountable in listed companies. This thesis argues that the market custom and over-regulation are to be held responsible for the lack of institutional investors’ activism in the U.K. In verifying the hypothesis of this thesis, empirical evidence was conducted.

1.2. Historical Background of Corporate Governance and Idea of the Thesis

The Companies Act '1985 (C.A. '1985 hereafter)\(^1\) provides the constitutional machinery for the governance of U.K. companies. The provisions in the legislation regarding the holding of general meetings (G.M. hereafter) of shareholders, the role and responsibility of directors,\(^2\) the nature of the articles of association and the memorandum of association\(^3\) are complemented by the role of the auditor reporting

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1 The reason for inserting a single closing quote symbol before the year 1985 is to indicate that it is the 1985 Companies Act as amended.

2 It should be noted that although directors’ fiduciary duties and the duty of skill and care has been developed through judicial decisions, courts in the U.K. are averse to interfere with the machinations of management and the ‘business judgement rule’. This reason is seen as a near insuperable barrier to successful action in challenging the stewardship of management. For a general discussion on directors’ duties in the U.K. see P. Davies, *Gower and Davies’ Principles of Modern Company Law*, (Sweet & Maxwell, London, 2003, chapters 14 – 18) and for general critiques on the duty of care and skill see C. Riley, ‘The Company Director’s Duty of Care and Skill: the Case for an Onerous but Subjective Standard’, (1999) 62, *Modern Law Review*, 679. See also, the earlier work of V. Finch, ‘Company Directors: Who Cares about Skill and Care?’, (1992) 55, *Modern Law Review*, 179.

3 The situation is similar in the U.S. See, A. Sommer, ‘Corporate Governance in the Nineties: Managers vs. Institutions’, (1990) 59 (2), *University of Cincinnati Law Review*, 357, at 358.

Although some aspects of the duties of directors will be discussed indirectly; i.e., recognising the division of functions between the board and G.M. and applying the general law of contract trusts and agency, this study does not deal with these aspects as such. It is beyond the objectives of this study to discuss these aspects in detail. This is because most of these aspects are in fact well researched.

3 See particularly, Parts I to V and VII to X of C.A. ‘1985.
Part One

Chapter One

on the accounts, and the freedom of companies to use or adapt model constitutional documents set out in the Companies (Tables A to F) Regulations Act 1985. This system is supported by rules developed by the courts; laying down the duties of directors, recognising the division of functions between the board and general meeting (G.M. hereafter), and applying the general law of contract, trusts and agency. In addition, for listed companies, the Listing Rules (L.R. hereafter) promulgated by the Financial Services Authority (F.S.A. hereafter), in its capacity as the United Kingdom Listing Authority (U.K.L.A. hereafter), requires a substantial additional level of transparency and disclosure.

A formalistic 'black letter lawyer' in reading only the legislation and the constitutional documents of companies, could be forgiven for seeing a clear and straightforward legal model of corporate governance based on a concept of 'shareholder democracy'. Shareholders/members elect and can remove directors who owe legal duties to the company to pursue its interests. The legislation and the company's constitution stipulate which powers are vested in the board and which belong to the shareholders, leaving the power to amend the constitution to the latter. The courts have ruled on the nature of that division of power and its implications.

4 Though very important in the area of corporate governance, the role of the auditor reporting on companies' accounts is beyond the objective of this study. This is not because there is no contribution to be made in this area. In fact, it is quite the opposite. For example, the independence of auditors is a subject that is very much under-researched and deserves the focus of a whole PhD thesis. The reason is rather the limitation of time to research such an area.

5 SI 1985 No 805.

6 This thesis deals predominantly with public listed companies. The American equivalent for public listed company is 'corporate' or 'corporation'. The terms 'public listed company', 'listed companies' and 'corporate' or 'corporation' are used interchangeably throughout the thesis.


9 See, in particular, section 303 C.A. '1985, ensuring the possibility of removing a director by an ordinary resolution.

10 See, B. Hannigan, Company Law, (Butterworths, London, 2003), chapters 4 - 8; and Breckland Group Holdings Ltd v London & Suffolk Properties Ltd [1989] BCLC 100.
Surely, under such a regime, there can be no issue about whether the company is run efficiently and in the interests of its shareholder ‘owners’.

Yet, since the early 20th century, literature in the area of corporate governance began to envisage a problem in the corporate governance system; namely, the disconnection between ownership and control. Veblen was probably the first writer to observe the phenomenon of ‘separation between ownership and control’ in modern corporations. Veblen’s two works, entitled: ‘The Theory of Business Enterprise’; and ‘The Engineers and Price System’, examined this phenomenon apparent in the modern corporation (i.e., separation of ownership and control), in which he described the emergence of a ‘new’ (at that time) kind of economic actor: the ‘manager-engineer’.

In the 1930s, following on from Veblen’s work, Berle and Means published their famous and well celebrated book; in all disciplines of research that are related to the area of corporate governance; entitled: The Modern Corporation and Private Property. Berle and Means argued that, in the case of a listed company with shares widely dispersed in small parcels among a large number of investors, there exists a separation of ownership and control; to such an extent that the constitutional mechanism of large corporations would fail to hold to account corporate managers. This argument is based on the availability of the option of selling a stake in the company on the stock market and the wish of shareholders as investors to maximise their return and minimise their costs, rather than spending money and other

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12 A. Berle, and G. Means, The Modern Corporation and Private Property, (The Macmillan Company, New York, 1933). It should be noted that the revised version (1968) of Berle and Means’ book is used interchangeably with the original version, of course with making the appropriate reference to the version cited. See also, Berle’s argument, in advocating that corporate managers should be held in trust of shareholders as sole beneficiaries of the corporate enterprise. This, in Berle’s opinion, would be the solution to the problem of corporate managers who may abuse their exclusive power because they usually lack substantial supervision from shareholders. (See, A. Berle, ‘Corporate Power as Power in Trust’, (1931) 44, Harvard Law Review, 1049).

13 Separation of ownership and control is known to be a common phenomenon in U.S. and U.K. corporations, whereas it is an exception in continental Europe.
resources on coalition building and participation in the ‘shareholder democracy’ system.\(^{14}\)

Berle and Means’ work nonetheless, did have its own omissions. For example, when published, it was criticised for failing to pay attention to the institutions’ role in corporate governance.\(^{15}\) However, despite criticism, the thesis of Berle and Means was well established and widely believed in relation to their work on the listed company. This was and still is (in part) to such an extent that since the Second World War, scholars in the U.S.A. and the U.K. have regarded the thesis of Berle and Means as a truism.

One of the fundamental notions outlined in Berle and Means’ thesis was that shareholders have a primacy status in holding corporate managers to account.\(^{16}\) Further to this, the debate in the area of corporate governance since then and until recently, focused primarily on for whom corporate managers should act as trustees.\(^{17}\)

\(^{14}\) It is alleged that the primary safeguard for shareholders in listed companies is supposedly, the ability to sell their shares. This is based on the assumption that the market is perfect. However, in a perfect market, the stock market should ideally operate as a daily plebiscite; enabling every single shareholder, regardless of size, to ‘register’ his or her individual reaction to what goes on in a corporation. Hence, the assumption is that shareholders would then be able to ‘register’ their concerns without having to be either a majority or build coalitions, in order to be able to win a vote in the G.M. Yet, this is a mere myth in an imperfect market. See, H. Manne, ‘Mergers and the Market for Corporate Control’, (1965) 73, Journal of Political Economy, 110; see also, R. Hessen, ‘A New Concept of Corporations: A Contractual and Private Property Model’, (1979) 30, The Hastings Law Journal, 1327, at 1345-1346.


\(^{16}\) In fact, Berle argued extensively that corporate managers should act as trustees for shareholders. He also made the simile that managers of large listed companies, i.e. those who truly control large corporations, are like princes and ministers who often make charitable donations on the state’s expense, which in Berle’s view justifies corporate social responsibility. (See, A. Berle, ‘For Whom Are Corporate Managers Trustees?’, (1932), Harvard Law Review, 1365, at 1367).

Berle also argues that corporate managers’ responsibilities to shareholders should not be weakened other than in situations where there is ‘a clear and reasonably enforced scheme of responsibilities to someone else.’ (ibid.)

Of course, the fear here is that if corporate managers were to be held accountable to many stakeholders groups, this would be similar to being accountable to none. This would entail that corporate managers have absolute power within the corporation.

\(^{17}\) The debate of for whom corporate managers should act as trustees is discussed in further detail in chapter three.
For lawyers, one of the central issues of debate throughout the history of the corporation, related to the issue of for whom corporate managers should act as trustees, is to whom corporate managers should be held accountable. The question lies on the appropriateness of shareholders as a group of market participants to hold corporations managers to account.\(^{18}\)

It should be noted here; at the beginning of this thesis, that the separation of ownership and control is only a problem if one views corporation law as a comprehensive functional description of corporate governance, in which there is a mechanism in place that is able to hold corporate controllers to account. Yet, some scholars across corporate governance disciplines do not believe separation of ownership and control to be a problem. They rather believe that the separation of ownership and control is a perfectly sensible division of labour. This is because such a division entails that investors, who have no experience in management but have the capital power, submit their capital to experienced corporate managers, who on the other hand, alone, lack the capital power to run their business. Hence, such a division of labour is supposed to produce good for both parties (i.e., corporation managers and shareholders). For example, Posner states:

\[\ldots\] the group [management group] consists of people who are experienced in the business and involved in it on a full-time, day-to-day basis. In contrast, the typical shareholder ... is not knowledgeable about the business of the firm, does not derive an important part of his livelihood from it, and neither expects nor has an incentive to participate in the management of the firm. He is a passive investor and, because of liquidity of his interests, has only casual, and frequently quite brief, relationship with the firm. His interest, like that of a creditor, is a financial rather than managerial interest \[\ldots\]

It is no more anomalous that shareholders do not manage or control 'their' corporation than that bondholders do not manage or control the corporations whose bonds they hold, or trust beneficiaries the trustee. All three groups have an investment interests.\(^{19}\)

For someone that takes such a view, it is similar to surrendering ultimate power within corporations to managers. It is true that most shareholders lack the ability to

\(^{18}\) It is not one of the study’s objectives to discuss the involvement of stakeholder groups in the corporate governance mechanism. The focus is rather on shareholders’ ability and willingness to hold corporate managers to account. Yet, references to this issue will be made when appropriate, throughout the thesis.
manage corporations on a day-to-day basis, but that hardly justifies the claim that corporate managers should go unmonitored and uncontrolled. Nor should it be the case that shareholders must be involved in managing the company on a daily basis. Their job is merely to monitor and control corporate managers. Otherwise, one would have to accept that the whole idea of constitutional and administrative mechanisms of the modern welfare state; in which citizens politically hold the Parliament accountable periodically and hence, Parliament monitors the Government; is fundamentally flawed. For those who believe in the latter, this thesis offers no possible middle ground for debate, and hence the case is rested. This thesis however, does offer an open minded and critical approach for those who believe in the accountability of corporate managers. One for example, would not wish to debate that other interests groups, such as creditors, employees and bondholders, etc have in many ways, interests that are ‘similar’ to shareholders’ interests in the corporation of today. Though, the argument that corporate managers should be accountable to more than one interest group of stakeholders is problematic in establishing a legal and market framework in the U.K.\textsuperscript{20}

It might be correct to say however, that shareholders generally, and institutional shareholders and investment managers in particular, should be more responsible in their control of corporate behaviour. Institutional investors and investment managers may fall short of having made serious attempts to influence corporate managers’ behaviour by invoking their rights as shareholders in relying on the stock market. If that is true, there may be reasons for it. Those reasons are related to institutional investors and investment managers’ ability and willingness to be involved in corporate governance issues which are the subject matter for discussion throughout this thesis. Of course, to contend that institutional investors and/or investment managers exert conclusive, direct control over the modern corporation is senseless too. It is similar to arguing for shifting the corporate governance problem, rather


\textsuperscript{20} The issue of the accountability of corporate managers to stakeholders rather than shareholders is briefly discussed below. See also, the King Report: <http://www.worldbank.org/html/fpd/privatesector/cg/docs/king.pdf> (May 2004).
than solving it. Nor should it be the case for one to argue, that institutional investors and investment managers should become involved in monitoring and controlling the day-to-day management of corporations. The argument here should be, rather, for a form of monitoring in which both institutional investors and investment managers monitor corporation managers' performance on a 'regular basis', ensuring that corporations are achieving their full economical potential as a corporation.

The problem however, is that even if institutional investors and investment managers are convinced that ethically, they should monitor and control corporate managers, doing so is still a financially unattractive option. This is because, in doing so, institutional investors and investment managers would have to hire a sufficient number of managerial personnel in all the corporations that they invest or manage investment in; to keep them informed of developments as well as performing their monitoring tasks correctly. This would no doubt impose enormous additional cost in a variety of ways, such as the salaries of managerial skilled personnel. Hence, institutional investors and investment managers may indeed question the wisdom of such an act. Of course, and as mentioned above, the other extreme that may be available to shareholders, in some cases, is to sell their equity. However, such an option is not always available to shareholders without a great loss. This is definitely the case if a corporation is experiencing, for example, financial trouble. Furthermore, one should not be naive in defining the matter as straightforward as the simple equation of the cost of monitoring verses institutional investors and investment managers' activism, when there is in fact much more to the debate. In relation to this, chapter two of this thesis discusses some of the economical reasons for the apathy of institutional investors and investment managers, in light of some of the empirical research conducted for this study.

For some legal scholars, there is no rationale at all behind the monitoring of corporation managers by institutional investors and investment managers, arguing that: 

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21 i.e., shifting it from what is conventionally known as the problem of inadequate monitoring of corporate managers to a new, (though the same in nature), form of
Part One Chapter One

[... ] what would be gained? The fund's managerial personnel are unlikely to be better qualified than those in the corporations and their additional "control" is unlikely to add much in the way of financial return to the pension fund while surely adding very substantial costs decreasing [institutional investors and investment managers] diversification. 22

Such an argument simply misses the point. The argument here is not only, who would be able to do what better, but also monitoring and ensuring whether those who could do it better (i.e., corporate managers) are actually doing it better, rather than diverting the corporations' returns to their own pockets. Hence, such debate leads one back to the argument that corporation managers need some form of monitoring and control. In relying on the principle of 'shareholders' primacy' maxim, institutional investors and investment managers may well be in the best position to perform such a job.

Shareholders' primacy maxim focuses on the fact that corporate managers should run the company to the best interests of its 'owners' (i.e. shareholders). According to shareholders' primacy theorists, the focus of corporate managers should be on shareholders' interests, since the interests of the rest of the stakeholders groups within the corporation are traditionally acknowledged and served by a variety of other laws and regulations. For example, employees' rights are, in theory, protected by employment laws. Nevertheless, it is also true to say that there is a common factor between the collective body of shareholders and the rest of stakeholders. This is because it is often important for a company to maintain its success by looking after its employees in order to retain them and ensure their loyalty. Moreover, with current growing public awareness of corporations' affairs, being socially responsible would no doubt enhance the support of the general public in such a corporation. Likewise, corporations need to take care of their suppliers, customers etc, to maintain business. 23


Yet, it remains the case that corporate managers' performance is by and large, judged on shareholders' profits in the form of dividends or capital gains. Hence, the success of a listed company is to a large extent, measured according to the profit it raises for its 'owners' (i.e., 'shareholders'). Shareholders of modern corporations are; rightly or wrongly, still the main stakeholder group in modern corporations. This view is still particularly popular, inter alia, because it is based on creating wealth for shareholders as 'owners' of the company, which would also eventually benefit other participants such as employees, managers and customers. Yet, one should not think that this is the end of the history of corporate law.

The popularity of shareholders' primacy led to its domination of U.K. company law. For example, in the U.K., powers are only distributed to two different groups of stakeholders, namely: shareholders and the board of directors. Therefore, the Cadbury Committee defines the corporate governance system as 'the system by which companies are directed and controlled.' The theory in which corporations are supposed to function, according to the law, is that shareholders should be able to assess the actions of their board of directors (the board as a whole and every individual committee within the board), and have, accordingly, the opportunity to query them and hold them accountable.

However, in the U.K., the ability to successfully hold boards of directors accountable to shareholders has proven to be difficult. The first and arguably foremost obvious hurdle to overcome, in the achievement of holding boards of directors accountable to shareholders, is identifying a good methodical model in which directors' performance accurately measure whether or not shareholders' value has been maximised. In other words, how and over what period of time, should a board of directors be accountable. The difficulty in making boards of directors accountable on the basis of the returns on shareholders' capital that the company has achieved however, is that there is no consensus about the period over which returns

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to shareholders and increases in share value should be measured. Performance can
be measured over a short term of one year at a time, or even longer, of for example
five or ten years etc. Nonetheless, it is rather unusual to measure returns over the
short term and assess performance in terms of profitability over a twelve-month
period. This is because, in the short term, a company's share price may be affected
by influences unrelated to the company's underlying performance, such as excessive
optimism in the stock markets generally. It is also the case that in the short term, it is
easier to soothe investors with a promise for the future, even though current
performance is not good. It is only when a company fails consistently to deliver on
its promises that investors' confidence ebbs away.

If a company's performance were to be judged by the returns to shareholders over a
twelve-month period, this would result in the focus of corporate managers on short-
term results. In elaborating on this point and reflecting on the reasons given by the
former finance director of Marconi for the company's financial collapse in 2000,
John Kay stated:

[A director's] job is to run a business that adds value by means of the services
it provides to customers. If he succeeds, it will generate returns to investors in
the long term. And this is the only mechanism that can generate returns to
investors.

The problem is that the equivalence between value added in operations and
stock market returns holds in the long run but not the short. Share prices may,
for a time, become divorced from the fundamental value of a business. This has
been true of most share prices in recent years [...]

In these conditions, attention to total shareholder returns distracts executives
from their real function of managing businesses. And their reactions in fact
reduce the ability of the corporate sector as a whole even to generate total
shareholder returns on a sustainable basis. This the price we pay for the
hyperactive capital markets of recent years.

What a fund manager needs most is a bull market - and the meta-fund
managers [...] Marconi, Enron and Swissair will not be the only businesses run
in these ways that will come to grief as the rising tide that once raised all boats
gradually ebbs. Perhaps we shall move into an age in which senior executives

American empirical research is inconclusive in the sense that there is conflicting
evidence on whether investors discourage corporate managers from managing on a
long term basis. Furthermore, American empirical research demonstrates conflicting
evidence on whether long term investment adds value to corporations or not (see The
Council of Institutional Investors, Does Ownership Add Value? A Collection of 100
Empirical Studies, (Council of Institutional Investors Publications: Washington DC,
1994)).
again understand that managing companies is not about mergers, acquisitions and disposals but about running operating businesses well; and that corporate strategy is about matching the capabilities of the business to the needs of its customers.27

Hence, the problem that remains is how corporate management could be made accountable for their long-term performance. It may be easy enough to assume that investors' commitment and understanding of the business, as well as taking a long-term investment view, is the solution. Yet, how could this be achieved? Of course, the argument here is not to say that the fact accountability is, *prima facie*, engendered with such a problem, validates that corporation managers go completely unaccountable. It is rather mentioned here to prompt a consideration of the extent of the predicaments surrounding the corporate governance system. In relation to this, legal scholars were urged to search for theories of the corporation that would either enhance the theme of shareholders' primacy or provides an alternative to it. The commentary of legal writers to the implications of this insight has varied according to their theoretical approach.28

A particularly influential school of thought since the 1980's up until the present day has been the 'Economic School Analysis of Law'.29 This theory has relied on external forces to solve the corporate governance problem. The scholars of this theory argued for the importance of the market as a mechanism for ensuring that managers as 'agents' prone to 'shirking',30 devote their efforts to the interests of shareholder investors, rather than their own perceived inclination to build turnover at


28 The different theoretical approaches to shareholders' legal status in the company and their effects on today's company law are discussed in chapter three of this thesis.


30 i.e., when an agent has less incentive to enhance a principal's interests, than if the principal was carrying out a delegated task him or herself. In other words, shirking refers to the fear that agents would not fulfil their obligations to those who employ them (principals).
the cost of profitability, or to minimise the effort they need to exert to earn their personal rewards. The market in corporate control was seen as a particularly important method of controlling managers. The myth here is if a corporation has the potential to perform well, yet it performs rather poorly, investors would see an opportunity to take the corporation over to exploit its full potential. If the takeover was to succeed, then the underperforming management would be removed. This would result in the control of assets by those capable of making the most efficient use of them, and would serve as a goad to others thinking of shirking.  

A takeover may be made by way of a 'proxy fight' (common in the U.S.), purchase of control, or merger. Corporate control as a solution for corporate governance is directly linked to a corporation’s share price. If the takeover is not performance/price related then it is called as 'hostile takeover'. The lower the share price of a corporation, the easier it would be for investors to take it over and hire a new team of management. Hence, if a corporation is either mismanaged, stolen from, or exceedingly attentive to nonprofit goals, inevitably, the price of its shares will drop. This may cause others to perceive the takeover as an opportunity to be exploited, by taking the corporation over and instating a new and more efficient management team to work on raising the corporation’s share price.

However, as times moves on, the popularity of a theory is prone to change. One of the main reasons for the decline of takeover/corporate managerial market popularity was in fact the hostile takeover. It is alleged that in some cases, poor performance


32 Proxy fight is a term that refers to the scenario when an investor or a group of investors try to collect proxies from other investors to defeat corporate managers’ proposals in the general meeting.

33 H. Manne, supra, n 14.

34 In fact, takeover was never an overwhelmingly popular method of corporate control in the U.K., or to be more accurate, takeover was never as popular in the U.K. as it
was not the drive for takeover; rather it was due to strategic reasons such as the manipulation of the market, owing to the fact that the market is inefficient. In the U.S.A., political pressure resulted in widespread legislation at state level, making takeovers more difficult. Across the world, the recession of the late 1980's and early 1990's made takeovers less common and led theorists to consider other methods of resolving the problem of separation between ownership and control in the area of corporate governance. Thus, this concern with the problem of corporate governance came to the forefront.

In the U.K., the Cadbury Committee Report with its supplemented 'Code of Best Practice' alongside its successors, which are contained within the 'Combined Code', was engineered to offer some assistance for companies to overcome some of the elements in the corporate governance problem, aiming to produce a more accountable board of directors. In the U.S.A., like the U.K., there was also a range of initiatives, which followed in the footsteps of the Cadbury Committee, including the American Law Institute Report on Corporate Governance. The California Public Employees Retirement System (CalPERS) also produced a code of best corporate governance practice called the 'Report Card' which, when published in 1994,
became front-page news in the mainstream business press. Nonetheless, it should be noted that the issue of shareholders' protection is more complex in the U.S. than it is in the U.K. The vast preponderance of legal scholars has observed the competition between the American States to attract corporation, to be the main reason for the lack of protection to shareholders. It is claimed by some legal scholars, such as Nader, that since the decision of where to incorporate is a management decision, and since the management's interests are adverse to those of shareholders, competition between the States in America tend to be tolerant to the conduct of management in failing to provide adequate protection for shareholders. This is commonly referred to in the U.S. as the 'race for the bottom'.

The 'Code of Best Practice' and the codes that came prior to it have, however, been criticised for taking the voluntarist approach, which is said to 'lack the teeth' to make a serious impact on improving corporate governance. Though not the perfect solution, nor is it meant to be, one can argue that prior to the 'Cadbury Code' in 1993, corporate governance practices were fairly unrecognisable in the U.K. The Cadbury Code did remain steadfast to management accountability to shareholders, and in no doubt formed the basis for good corporate governance practices. It also opened the gateway widely for other codes to follow, introducing the amendments

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42 For example, Riley used such a phrase. See, C. Riley, supra, n 38, at 123.

and improvements needed in the market. For example, these codes introduced various aspects to improve the accountability of corporate managers to shareholders.

Furthermore, the other part of the ‘Code of Best Practice’ approach is transparency. This entails that if a company is not complying with the code then they should justify why. Hence, there is no doubt that the ‘Code of Best Practice’ has achieved a sounder corporate governance system in the U.K., by stressing the ‘obligation’ of corporations to justify non-compliance, and leaving it to the market to judge those justifications. Hence one might argue, that in the U.K., the ‘Code of Best Practice’ has to a certain extent, managed to alter the focus of corporate governance from

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44 Historically, and as the Cadbury Committee recommended upon the publication of its Code (Report of the Committee on the Financial Aspects of Corporate Governance, (Gee Publishing Ltd, London, 1992), considerable supplements have been added to the Code of Best Corporate Governance Practices. In 1995, for example, the Greenbury Code was introduced into the Greenbury Report by the Greenbury Committee, (Report of the Committee on the Financial Aspects of Corporate Governance, (Gee Publishing Ltd, London, 1995). The main focus of the Greenbury Report was directors' remuneration and the length of directors' service contracts. In 1998, the Hampel Committee was set up to continue the review of corporate governance practices that were started by the Cadbury and Greenbury Reports, suggesting that the recommendations of all three committees should be incorporated into a single code of corporate governance, which was then published as the Combined Code (The Committee on Corporate Governance, The Combined Code, (Gee Publishing Ltd, London, 1998)). In 1999, the Turnbull Committee published a report giving guidance on how directors should carry out their responsibilities for the internal control system, as required by the Combined Code (Internal Control: Guidance for Directors on the Combined Code, (Gee Publishing Ltd, London, 1999)).

45 The company’s statement of compliance with the Combined Code should include whether the company has introduced measures to ensure the effectiveness of the board, such as: whether the roles of chairman and chief executive are separated; balance of executive and non-executive directors; supply of information to the board; procedures for the appointment of new directors to the board; and, whether all directors are subject to re-election at least every three years.

The statement of compliance also includes: the level and components of remuneration; procedures for setting directors remuneration; and, disclosure of remuneration policy (Para 12.43 (A) (C) of the Listing Rules). Furthermore, the statement of compliance should include; whether measures have been taken by the company to improve relations with its shareholders. For example, dialogue with institutional shareholders and the usage of the annual general meeting (AGM hereafter) to communicate with private investors and encourage their participation in corporate governance, particularly voting.

The self-regulatory issues of corporate governance are not the focus of this study and only mentioned here as a part of the historical development of corporate governance in the U.K. (These issues are all discussed in more depth throughout this thesis).
being exclusively on market forces, to include the internal governance of companies; in particular the role of shareholders (i.e., the revival of 'shareholder democracy').

Although it might be suggested that the 'Code of Best Practice' no doubt improved our corporations, it is still yet a mere illusion for one to believe that if a corporation complies with the 'Code of Best Practice', this would automatically mean that it is performing well. From the perspective of performance, shareholders (particularly institutional shareholders) who purport and hence advertise that they are actively involved in corporate governance issues, should not be fooled to believe that by following the so-called 'moral campaign' or 'a box-ticking, compliance issue' a sound corporate governance system can be achieved. This on its own would most definitely not get corporate performance anywhere. Instead, and as noted by Herms, companies with active and informed shareholders will achieve superior performance. In Herms' view, being an active institutional shareholder enhances returns, enables them to meet their obligations to their beneficiaries and hence, increases market trust in their business.

Whilst conducting the research for this thesis, the government commissioned two independent reviews on the effectiveness of the internal corporate governance system in the U.K. The first review, which was published on 20 January 2003, was entitled: 'Review of the Role and Effectiveness of Non-executive Directors' (the Higges Review hereafter). The second review, which was published on 6 March 2001, was entitled: 'Institutional Investors in the UK: A Review' (the Myners Review hereafter). At the time of writing this chapter, the Higges Review was incorporated into the 'Code of Best Practice', and the Myners Review

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46 The two main methods of internal governance are: the role of non-executive directors in keeping good corporate governance; and, institutional shareholders' role in keeping good corporate governance. It is the latter that this study is concerned with.


48 ibid.


50 P. Myners, supra, n 43.
recommendations are also expected to be incorporated into the ‘Code of Best Practice’, adopting the self-regulation style i.e. a voluntarist approach, allied with transparency. The fact that the Government commissioned these reviews reflects two things: the first is that the effectiveness of the corporate governance system remains in question as far the U.K. Government is concerned; and the second is that the Government perceives a possible solution in encouraging the internal model of corporate governance.

On both sides of the Atlantic, there are already some institutional investors who could be classed as ‘active’ investors. For example, Herms and CalPERS are institutional investors who are known to be closely engaged with under performing corporations’ managers; whose role is not to take the corporations over, but to improve them via the existing managers. In their engagement with underperforming corporations, those active investors could use a variety of methods to put pressure on corporations’ managers, such as threatening to use their voting power to force changes through the G.M. vehicle, or more drastically, to replace the chief executive if performance targets are not met. Nonetheless, many institutional investors are passive in relying on diversification and exit methods, rather than taking the approach of being directly involved.

As for enhancing the role of non-executive directors, much emphasis has been placed on their independence and their relationship with shareholders, particularly significant shareholders. The Anglo-American board of directors often consists of executives and non-executive directors, in which the former, rather than the whole board, manage the company. The board, on its part, is supposed to form the company’s general policy decisions and oversee corporate managers (executive

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53 The reason for the Combined Code of ‘Best Corporate Governance Practice’ persistently recommending a majority of non-executives in the board, as opposed to executive directors, is to help balance power in the board.
directors) in their performance of their duties.\textsuperscript{54} As Esen points out, the idea behind non-executives monitoring corporate managers is two-fold: firstly, some corporate managers lack certain skills or may lose skills that they once acquired. Hence, non-executive directors rule here is make sure the executive directors do actually have the skills needed for running the business of the corporate efficiently; and secondly, developing a safety valve in which corporate managers do not become the absolute power. This is because if this safety valve is not put in place some corporate managers would find it easier to concentrate on maximising their own interests, rather than those of the corporation in the long term.\textsuperscript{55} Yet, this system could only be effective if non-executives have the competence, objectivity and independence to carry out such monitoring.

Without drawing on the issue of non-executive directors much further; since it not one of the main issues that this thesis wishes to address; the competence, objectivity and independence of non-executives were among the subjects identified to be vitiates with problems concerning the current role of non-executives directors in corporations. In discussion leading to the Company Law White Paper, board collective responsibility was considered, but unfortunately rejected. Instead, the plan now and as the Higgs Report\textsuperscript{56} suggested, is to provide a training course for non-executives to acquire more competence. Yet, it should be recognised that collective responsibility would result in a greater sense of responsibility on the part of non-executives. Thus, they might spend a much longer amount of time on the corporation’s business, rather than the current approach of spending approximately no longer than 125 hours per year.\textsuperscript{57} Of course, this would mean that non-executives are paid more, but corporations would probably perform better and therefore, the


\textsuperscript{55} ibid. at 202.

\textsuperscript{56} D. Higgs, supra, n 49.

advantages outweigh the disadvantages. Moreover, if cost is an issue, then there is probably no point in having ineffective non-executive directors at all.

As for the accusation made against some non-executive directors that they are neither objective nor independent, it is the case that in some public listed companies in the U.K., non-executive directors are practically speaking, appointed by executive directors. If this is the case, executive directors would logically appoint those who are likely to support them, usually a 'social friend of, or a member of the same club as the chief executive director'\(^{58}\) (the so-called 'old school boys network').\(^{59}\) This is thought to cause an ostensible conflict of interests. Furthermore, there are no regulations that have been put in place yet, in either the U.K. or the U.S. markets, against what one could call the 'dual role of non-executive / executive directors'. This can be illustrated by the following example: a non-executive director of (X) company could be serving as chief executive in (Y) company, in which a non-executive director is serving as chief executive in (X) company. Such a scenario would in no doubt affect non-executive monitoring of corporate managers.\(^{60}\)

Following up on recommendations from the Higgs report, the Tyson Report\(^{61}\) was published, drawing on the independence of non-executive directors. The Tyson Report recommended institutional investors involvement in the appointment of non-executive directors to ensure their independence. Others may suggest creating an independent body that trains and appoints non-executive directors in corporations. However, one may argue that both the latter and the Tyson Report suggestions are flawed for the simple reason that they may create tension between executive and non-executive directors. Either of those suggestions could indeed insure the independence of non-executive directors, but may result in a reluctance of

\(^{58}\) R. Hessen, supra, n 54, at 203.

\(^{59}\) See generally, D. Higgs, supra, n 49.

\(^{60}\) R. Hessen, supra, n 54.

\(^{61}\) The report is entitled; 'The Tyson Report on the Recruitment and Development of Non-Executive Directors', issued June 19th 2003. For a full electronic version of the Report see:

cooperation between executive and non-executive directors. Corporations as profit making vehicles above all need boards that work. There is no doubt that there should be some sort of effective relationship between executive and non-executive directors. Hence, the training of non-executives to be independent; ensuring their loyalty to the company, mixed with a piece of legislation that enforces board collective liability, could result in non-executives that are more vigilant in monitoring corporate managers.

It is not one of the objectives of this thesis to draw in depth on the issues related to non-executive directors, but it is worth mentioning here, that the study provides empirical evidence on the extent to which institutional investors and investment managers would consider having dialogue with their corporate managers, if they have a concern about the company’s performance, before considering having dialogue with non-executive directors. This demonstrates that the relationship between shareholders and non-executives has not yet really been exploited enough in the U.K.62 The author believes that non-executives could potentially play a very important role in U.K. corporate governance. The importance of non-executive directors can be divided into two main levels: the first is the role that non-executive directors could play in monitoring executive directors directly, e.g. suggesting an alternative to executive plans in the board of directors’ meetings. The second is the role that non-executive directors could play in cooperation with shareholders to defeat executive directors’ plans. The author intends to research the above subject in future research projects.

As for institutional investors, the Myners Review did provide some answers to aspects related to their structure, rationale and behaviour.63 This study on the other hand, focuses on institutional investors and investment managers’ ability and willingness to control modern corporations, principally in the U.K. The study embarked on collecting empirical evidence which examines alleged reasons that legally and socially (related to customary investors in a set market) might hinder

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62 See, earlier discussion in this chapter.
63 P. Myners, supra, n 43.
investors in general, and institutional investor and investment managers in particular, from effectively monitoring and controlling corporate managers.

A number of American scholars such as Coffee have written about the significance of institutional investors' holdings in today's American stock markets.\(^{64}\) Similarly, scholars in the U.K. such as Farrar and Russell,\(^{65}\) began to notice the creeping influence of institutional investors and investment managers in the London Stock Exchange (L.S.E. hereafter), when in fact, the dominance of such investors probably became obvious at an earlier date than its counterparts in the U.S.A.\(^{66}\) Most likely due in part to the late 1980 markets crash and witnessing examples of active institutional investors such as Herms, CalPERS, etc.,\(^{67}\) legal scholars were prompted to write about the new phenomenon of the plausibility of institutional investors in monitoring and controlling corporate managers, particularly in the U.S.\(^{68}\)

In the U.K. and Australia, the work of Stapledon explored the scale of the holdings of institutions and the relationship between institutions and investment managers.\(^{69}\)

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67 More recently, an example of the interference of institutional investors in corporate governance issues was when institutional investors asked the British Telecommunications (BT) non-executive directors to name a successor to Iain Vallance (the chairman) in 2001, before the time of the next G.M. For more details on this case see, V. Criscione, S. Targett and A. Van Duny, ‘Shareholders Tell BT to Step Up Search for Vallance Successor: Latest Unrest Could Prompt Chairman's Early Resignation and Worldwide Search for Replacement’, (Financial Times, 17 February 2001), 1.
In the U.S.A., debates ensued about the relevance of political and legal factors in constraining institutions from an activism in which they might otherwise engage.\textsuperscript{70} Moreover, McCormack commented on institutional shareholders' ability to enforce the 'Code of Best Practice' upon corporate managers in the U.K.\textsuperscript{71} However, in the U.K., there is a gap in the literature in the area of institutional investors' activism, particularly with regards to the attitudes of institutional investors and investment managers towards each other, to the management of the companies in which they invest, to the markets, and to the use of legal remedies to deal with problems. There is certainly a need for empirical evidence to help understand the relationship between institutional investors and investment managers. For this reason, this study embarked on two questionnaires to shed light on the behaviour of institutional shareholders and investment managers, and whether they hold the answer to providing a sound corporate governance system in the U.K. Evidently, the importance of these two groups comes from the large stack that they hold and manage in the L.S.E.\textsuperscript{72}

The debate on whether there is, or may be, an international convergence of corporate governance systems, and whether differences between legal systems on points of corporate law or securities law, may give rise to factors relevant to the efficiency of markets, has played its part in this.\textsuperscript{73} Therefore, there has also been a willingness by some writers to reassert the importance of legal concepts such as 'authority in

\begin{footnotesize}
\begin{itemize}
\item The structure of share ownership in the U.K. is discussed below in this chapter.
\end{itemize}
\end{footnotesize}
agency' and the 'reality of power and authority' in corporate hierarchies.\textsuperscript{74} This has been used to support the role of fiduciary duties as a means of policing 'sharking'\textsuperscript{75} against arguments that the regulation of shirking and agency costs might be an optional matter of contractual agreement between those involved in companies – seen as a ‘nexus of contracts’\textsuperscript{76} by some proponents of the ‘neo-economic theory of corporation’.\textsuperscript{77} Given that this study is concerned with the status of shareholders, chapter three of the thesis discusses the theoretical approaches to shareholders in listed companies in more depth. Further elaboration will focus on the influence of those different theoretical approaches on shareholders’ legal status in the U.K., particularly shareholders of public listed companies; supporting the argument with empirical evidence of the application of contractual theory in contemporary U.K. listed companies.

Parallel to the above-mentioned two reviews on non-executive directors’ and institutional shareholders’ involvement in corporate governance, the whole of company law is undergoing review in the U.K. One of the fundamental issues that the company law review discussed which in part, acknowledged difficulties in holding corporate managers to account before shareholders, was whether to include stakeholders groups other than shareholders in the equation of the distribution of power within the U.K.’s companies. At the time of writing this thesis, the review reached the stage of being contained in the Company Law White Paper.\textsuperscript{78} The

\textsuperscript{74} E. Orts, supra, n 30.

\textsuperscript{75} i.e., opportunism, but it does not necessarily mean violation of a director’s fiduciary duty or agency responsibilities. According to Orts, ‘Sharking involves not merely the diversion of assets from the firm for a selfish gain. It instead involves the calculated misuse of power and authority within the firm to benefit one general interest in the firm at the expense of another.’ Hence, sharking refers to the abuse of power by those who control corporations by taking actions that benefit some individuals in the corporation rather than the entire corporation. See, E. Orts ‘Shirking and Sharking: Agency Law, Agency Costs, and a Dual Theory of the Firm’, (11/01/1999) Research Center: Legal Studies Department: <http://knowledge.wharton.upenn.edu/papers/558.pdf>, at 77 (June 2004). See also, E. Orts, supra, n 30.

\textsuperscript{76} ibid.

\textsuperscript{77} See chapter three of this thesis for more details on nexus of contracts.

\textsuperscript{78} Modernising Company Law: Presented to Parliament by the Secretary of State for Trade and Industry by Command of HM July 2002, Cm 5553-I & II.
changes suggested to shareholders' status in the Company Law White Paper are briefly discussed in the next section.

1.3. Company Law Review and Stakeholders' Interests

Under the C.A. '1985, shareholders are given certain rights, which includes that the board of directors is accountable to the collective body of shareholders (i.e. the G.M.). On the other hand, the board of directors owes duties to the company, such as the duty of skill and care and the duty to act in a \textit{bona fide} manner. Although, the board of directors do not owe particular duties to individual shareholders (it is rather to the G.M.), shareholders could still, in theory, enforce measures to their best interests, through the power vested to them by the company law, (i.e., holding corporate managers accountable, etc). The interests of other groups of stakeholders are not enforced, however. Section 309 C.A. '1985, for example, requires that directors should have regard for managing the company and the interests of the company's employees in general,\footnote{Section 309 of the C.A. '1985 does not only refer to the mere negative directors' duties of refraining employees from overworking or injuring themselves, that comes from employment law, but also the affirmative duty of providing employees economic security.} as well as the interests of shareholders. Yet, being non-specific and open to wide interpretation has resulted in rendering this provision to have little if any affect at all. Put simply, under s. 309 C.A. '1985, managers 'can', rather than 'should', have regard for employees' interests, if it does not conflict with shareholders' interests.

At an early stage of the U.K. Company Law Review (C.L.R. hereafter), the issue of whether boards of directors need to promote stakeholders' interests was raised.\footnote{C.L.R. \textit{Steering Group, Strategic Framework}, 1998, Ch. 5.1.} The C.L.R. stated that U.K. company law presently, does not embrace the 'enlightened shareholder approach',\footnote{i.e., the board of directors should run the company in the interests of equity shareholders, while at the same time, taking into consideration the interests of other stakeholder groups.} asking whether future company law needs to
promote this approach or even the 'stakeholders/pluralist approach'. Most of the response was in favour of the 'enlightened shareholder approach', which is now echoed in the Government's Company Law White Paper.

Under the Company Law White Paper, directors must act *bonae fide* in accordance to what would most likely promote the success of the company for the benefit of the collective body of shareholders. However, it further recommends that:

- directors should also recognise, as the circumstances require, the company's need to foster relationships with its employees, customers and suppliers, its need to maintain its business reputation, and its need to consider the company's impact on the community and the working environment.

From this statement, one can deduce that management can consider the interests of other stakeholders in the company so long as it goes in harmony with the requirement of enlightened shareholders' interests. In fact, classifying the actions of management as that which goes in harmony with the enlightening of shareholders' interests is not that demanding a test to be established. This is because; (as is the nature of the business judgment); it is relatively easy to justify actions taken by corporate managers in the benefit of a stakeholder group, other than shareholders, on the basis that it benefits the survival of the corporation in the long run. It has to be said however, that the position of corporate management in its consideration of stakeholders' interests is not entirely new. Directors have always managed to justify modest, business related, political or charitable donations, relying on Bowen L.J.'s, (although in the context of *ultra vires*) statement that: 'The law does not say

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82 i.e., the board of directors should run the company, balancing the interests of equity shareholders with the interests of other stakeholders groups that are committed to the company.


84 ibid.

85 See, P. Davies, supra, n 2, at 378.

86 Though, the causation particularly between contributions to political parties and the survival of a company is rather faint and should be hard to justify in the U.K.

87 It must be said though that there are a whole set of issues related to donations such as whether or not disclosure of those donations needs approval of the G.M., which are beyond the scope of the discussion of this thesis.
that there are no cakes and ale, but there are to be no cakes and ale except such as are required for the benefit of the company.\textsuperscript{88}

Hence, the White Paper has not departed from shareholders' primacy position in companies, but more exactly, adds to the existing common law; a duty on the part of directors to consider the interests of other stakeholders when it benefits shareholders. This is not necessarily a good thing. Such addition to the existing common law duties may create vagueness concerning the role of corporate managers, by giving the impression that the law is departing from the primacy position of shareholders in corporations. Moreover, such a proposal does not solve the problem in listed companies of the lack of directors' accountability to shareholders. It rather enlarges the existing problem.\textsuperscript{89} Although the U.K. legislature is in favour of shareholder's primacy status, they nevertheless did not want to give shareholders the false impression that they could abuse other stakeholders. However, one can argue that maintaining the current stance on shareholders' primacy position is more suitable than the newly proposed one. This is because it gives a clearer status to shareholders.

Rightly or wrongly, the prominent approach in company law is and in the foreseeable future likely to be, shareholders' primacy. The 'black letter law' therefore, focused on shareholders as a collective body in the form of the G.M., which allegedly has the ultimate power in the company. Nonetheless, in listed companies, where shareholdings are widely dispersed and because of agency costs, it might be difficult and impractical to justify forming collective action, if the option of exit is available. Therefore, the option of exiting companies due to its easy nature, in some cases, does create an obstacle for shareholders to form or who wish to form, an effective monitoring body that is able to take collective action. Yet, the debate that followed the emergence of institutional shareholders as the stock market's main players in the 1990's, brought a glimmer of hope for embracing the constitutional

\textsuperscript{88} \textit{Hutton v West Cork Railway Co.} (1883), 223 ChD 654, at 673.

\textsuperscript{89} i.e., such a position may give some directors a cover to justify actions that are clearly not benefiting shareholders.
machinery set by both U.K. and U.S.A. corporation laws. In relation to this, the next section deals with the construction of shareholders’ ownership in the U.K.


Equity markets in the U.K. and the U.S. are defined as market-oriented stock exchanges, as opposed to most of the other equity markets in the world, which are referred to as network-oriented stock exchanges. The objective of this section is to introduce information on the U.K. equity market and its ownership structure, which is relevant to the discussion throughout the thesis. According to some hypotheses, shareholders can be classified into nine different categories: individuals; non-financial companies; public authorities; foundations; banks; insurance companies; pension funds; investment funds; and, foreign shareholders. The classification of the Office for National Statistics (O.N.S. hereafter) is slightly different. The O.N.S. classifies shareholders into twelve different categories, which are: the rest of the world; insurance companies; pension funds; individuals; unit trusts; investment trusts; other financial institutions; charities, etc; private non-financial, companies; the public sector; and, banks. Table 1.1., below, illustrates the distribution of share ownership in the U.K.

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91 ibid. at 21.


93 ibid. at 9.
According to the O.N.S. survey, the value of listed ordinary shares on 31 December 2001, was some £1,554 billion. Together ‘institutional investors’ including: insurance companies; pension funds; unit trusts; investment trusts; and, other financial institutions, held 50% of the market; some £776.3 billion. The two biggest institutional investors groups, holding over 36% then, were insurance companies and pension funds (these two groups are the groups referred to as institutional investors or institutional investors in this thesis). Insurance companies held £310.6 billion, which accumulates to 20% of the whole ordinary listed market value. Pension funds share ownership has however, decreased significantly from the mid 1990s up until now. It fell from over 31% at the end of 1993, to over only 16% by the end of

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Table 1.1


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94 ibid. at 4.
95 The decline referred to is in terms of percentage rather that value of holding in money.
2001. This is due to changes in the law, *inter alia* the 1995 reform. For example, a change introduced in the Pensions Act 1995, requires that the whole of an occupational pension is subject to retail price indexation or 5% in tax; whatever is lower.

In the U.K. and the U.S., majority shareholders’ control in public listed companies, in the legal sense of the word, hardly exists. Majority shareholders control about 10 to 12% of the listed companies. What is more, most of those 10 to 12% majority controlled companies only take place in the context of a contest of takeovers. It is also known that U.K. insurance companies are highly diversified. In spite of holding 20% of the L.S.E.’s value, insurance companies recently declared notified interests of just 1.5%. The L.S.E. is a very liquid market and it is not the norm that investment reaches 5% or more. In fact, stakes larger than 5% only account for 14.4% of the whole market’s stocks. Furthermore, the majority of the other large U.K. institutional shareholders’ groups (i.e. pension funds) do not directly manage their investment. The majority of pension funds rather employ external fund managers to manage their investment.

Generally, institutional shareholders’ share ownership was in steady and fast growth from the 1960s up until 1993. Rightly and from a theoretical point of view, the growth of institutional shareholders was thought to hold the answer to the problem of separation between ownership and control. Concentration on share ownership in

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96 C. Van der Elst, supra, n 90, at 28.
97 The change was effective from 6 April 1997; see also P. Myners, supra, n 43, at 30.
98 A. Von Buddenbrock, ‘Abwehrstrategien gegen feindliche Übernahme’ in DAI (ed.) Die Übernahme Börsennotierten Unternehmen, (Frankfurt, Am Main, 1999) at 278-279. The source was not accessed directly, rather it was quoted from C. Van der Elst, supra, n 90, at 39.
99 ibid. at 45.
100 ibid. at 42.
the hands of a small number of institutional shareholders would be likely to make collective action more feasible. McCormack for example, argued that institutional shareholders are able to enforce the ‘Code of Best Practice’ upon corporation managers in the U.K. This contention may be agreeable, yet the question remains as to whether shareholders are willing to take such an action. If so, then the further question that arises is: are institutional shareholders willing or indeed able to do anything beyond enforcing the ‘Code of Best Practice’? Surely, enforcing the ‘Code of Best Practice’ may be one of the reasons for enhancing corporations’ performance, but it is not the sole reason. Solitarily arguing for the ‘Code of Best Practice’ to be enforced is like box ticking, in which one could miss the whole point behind monitoring. Rather, the real point behind monitoring, one could argue, is that investors are truly involved in corporate governance issues and probably if needed, sharing their expertise with corporations’ managers, in order for the company to achieve better results.

1.5. Objectives of the Study

This thesis is not primarily concerned by corporations’ compliance to the ‘Code of Best Practice’, related codes and regulations, and how institutional investors could enforce such practices. Rather, this thesis argues that in order to add economical, financial and social value to corporations, institutional investors must have a clear agenda in relation to being involved in the governance of corporations. Hence, this study examines the main protections and legal barriers that affect shareholders’ ability and willingness to monitor, control and be involved in corporate governance in U.K. public listed companies.

There are two main objectives in this study: first, to examine the reasons that affect shareholders’ willingness to monitor and control corporate managers; and second, to consider the reasons that affect shareholders’ ability to monitor and control corporate managers. This study offers the results of two questionnaires, to provide insight into how the supposed protections to shareholders and the legal obstacles they face in monitoring and controlling corporations are perceived by institutional investors.

shareholders and investment managers; placed in the position of the main security market participants in the U.K. Hence, the focus of this study lies on the internal governance of the U.K.'s public listed companies and the role of institutional shareholders within that context, evaluating the current internal governance system in the U.K.'s public listed companies.

The first objective of this study, in examining the willingness of institutional shareholders to participate in the governance of the U.K.'s public listed companies, was accomplished by analysing and testing legal and hypothetical capital market constraints that may affect institutional shareholders' and investment managers' ability to control and hold to account corporate management, causing them to be inactive. These constraints include: thin equity; diversification; liquidity of shares; reliance on other shareholders; apathy of shareholders' agents; keeping access to soft information; comparison with other investment managers' performances and market indices; conflict of interests; short termism; management's manipulation of the G.M.'s agenda; political retaliation; investing in index funds; the fear of being considered as shadow directors; the fear of being locked in the company; and, the fear of committing an insider dealing offence.

The main reason for testing these possible constraints was to discover whether there are external reasons, which make shareholders inactive. There has been a great deal of speculation on these possible constraints in the U.S.A., and it is argued that the situation is similar in the U.K. Yet, little empirical research has been conducted on these possible factors and the extent of their effects on investors' willingness to monitor corporations and their managers. Thus, this study embarked in gauging institutional investors and investment managers' opinions about the effects of these possible constraints on the U.K. market. Nonetheless, this study acknowledges that the results given are indicative and not conclusive, and should be subject to further research and examination.

103 G. McCormack., supra, n 71.
104 J. Coffee, supra, n 64.
105 ibid.
With regards to achieving the second objective, this study assessed four main methods that shareholders can use to influence corporations and their managers or hold managers to account. These methods are: shareholders’ self help; using litigation to hold corporate managers to account; voting and the proxy system; and, using dialogue to monitor and influence corporate managers. This method of influencing corporate management through the actions of shareholders is based on perceiving the corporation as a contract between investors and controllers. Hence, according to corporation contractual theory, shareholders can negotiate the terms of the company's constitution, which includes allowing terms to be agreed and included in the company constitution at the stage of promoting a company -so far as they are not contrary to public policy- as well as allowing the G.M. to change the company constitution after it has been registered. Yet, all this is mere speculation and lacks empirical observation to support or indeed refute it. The questionnaires of this study offer some insight to institutional shareholders and investment managers’ viewpoints on interference in changing company constitution.

The second method used by shareholders to influence corporate governance and hold corporate managers to account is litigation. The problems facing minority shareholders seeking a derivative remedy for directors’ breach of duty are well known in the English legal system. The notorious rule in *Foss v Harbottle* and the reluctance of the courts to ease the position of those seeking to take advantage of 'exceptions' to the rule was exemplified in cases such as *Prudential Assurance Co Ltd v Newman Industries Ltd* and *Smith v Croft* which indicate that legal remedies are unlikely to be prominent in the thinking of institutional investors or those managing their investments on holding corporate management to account. This remains the case, despite some signs in the legal literature that belief in the

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106 As far as this study is concerned, shareholders self-help refers to when shareholders implement suitable terms in the company’s constitution that tighten the hands of management and give shareholders more power to be able to hold corporate managers to account.

107 See chapter three for an in depth analysis of corporation contractual theory.

108 (1843) 2 Hare 461.

significance of the content of company law rules and the role of legal, as opposed to economic analysis, has recently enjoyed a revival.

The third method used by shareholders to influence corporate governance and hold corporate managers to account is the voting and proxy system. This study offers an empirical insight into how seriously institutional shareholders and investment managers treat the G.M. and proxy voting. Shareholders can express their voice directly through attending and voting in the G.M. or alternatively, shareholders can indirectly express their views through delegating to company management or to a third party to vote on their behalf. Voting directly or indirectly is known as 'shareholder democracy', which is one of the main principles of a company's function that is set out by company law. If shareholder democracy is used effectively, it can be without a doubt the shareholders' strongest tool in holding management to account. Yet, that is only true if institutional investors and investment managers’ voting is based on good information and the will to change things for the good of the corporation, rather that being a rubber stamp for corporate managers. Voting, as a way of influencing managers and holding corporate managers to account, offers a range of different devices, from blocking management proposals that do not enhance company value or shareholders’ profitability, to voting management out of office.

The fourth method used by shareholders to influence corporate management is dialogue. It is thought that in the U.K., institutional shareholders and investment managers do use dialogue as a means of influencing corporate management. Moreover, it has been alleged that institutional shareholders in U.K. public listed companies use dialogue extensively as an instrument for holding management to account. Some legal scholars assert that institutional shareholders and investment managers exploit dialogue with management behind the scenes to avoid damaging,

111 See G. Stapledon Institutional Shareholders and Corporate Governance, supra, n 69, and J. Coffee, supra, n 64.
negative publicity. This study examined this allegation by empirically testing the availability of dialogue as a means of forming a coalition able to hold corporation managers to account, mixed with the legal constraints of dialogue.

1.6. Organisation of the Study

This thesis is organised into seven chapters that can be divided into four parts. Part one of this thesis includes this chapter and chapter two. Chapter one has introduced the framework of corporate governance in the U.K. arguing that institutional shareholders' share ownership has revived the possibility for overcoming some of the corporate governance problems in U.K. listed companies. Chapter two provides empirical results on reasons that may negatively affect shareholders' willingness to monitor and hold corporate managers to account. Part one of the thesis concludes that the current economical framework of the market does in no doubt, negatively affect the willingness of investors to monitor and control corporate managers. Hence, to say the least, the market's economical framework does not help institutional investors and investment managers in holding the key to good corporate governance in the U.K. Yet, if shareholders are still undeterred by the negative impact of the economical framework, then one needs to examine whether or not the legal framework of companies helps institutional investors and investment managers in holding the key to a good corporate governance system in the U.K.

The issues that surround whether or not the legal framework helps institutional investors and investment managers in holding the key to a good corporate governance system in the U.K. are discussed in part two and three of the thesis. Part two addresses the main means that are available to institutional investors and investment managers to hold corporate managers to account, while part three discusses whether or not it is possible to establish dialogue among institutional investors and investment managers themselves, as well as with corporate managers, to help achieve good corporate governance.

112 See G. Stapledon Institutional Shareholders and Corporate Governance, supra, n 69, and J. Coffee, supra, n 64.
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Specifically, the second part of this thesis is organised into three chapters. Initially, chapter three draws on the main underpinning theories of the corporation; namely: corporation communitaire theory; corporation concession theory; and contractual theory of corporation. The aim of introducing these theories to the context of this thesis is to understand their influence on shareholders’ legal status in the U.K. Moreover, chapter three offers an in depth analysis; supported by empirical evidence, in discussing the use of the latter theory, to enable shareholders to exploit self-help remedies. It is thought that to negotiate more protective terms for their interests with corporate managers, shareholders could use contractual theory. The empirical evidence in this chapter tests the accuracy of such an allegation, drawing on the significance of corporate constitutions. Chapter four discusses the availability of litigation to shareholders in the case of corporate management misconduct. Chapter five considers the effectiveness of the shareholder democracy system through voting in the G.M. and the use of proxies. Part two of the thesis concludes that none of the traditional means as they stand today offer the key to holding corporate managers to account. Yet, institutional shareholders and investment managers could resort to dialogue with corporate managers to achieve better corporate governance and may also be able to use dialogue among themselves to collectively hold corporate managers to account.

Part three of this thesis includes chapter six, which discusses the use of dialogue as a means to monitor and influence corporate managers. In particular, this chapter deliberates the legal reasons that restrict dealing upon having price sensitive information and the legal reasons that affect shareholders’ ability to have dialogue with corporate managers. Furthermore, this chapter reviews the legal reasons that might affect coalition building amongst shareholders in order to be able to hold management to account. Finally, the fourth part of this thesis consists of chapter seven which presents a summary and conclusions of the thesis.

In helping to achieve the objectives of this study, the author examines the primary and secondary legal sources. Further to this, the author executed two questionnaires. The first questionnaire examined institutional shareholders’ behaviour in monitoring corporations and their managers. The second questionnaire examined investment
managers and the role they play in monitoring and holding corporate management to account. Not as significant in terms of share ownership in the stock market, investment managers are far more important as agents of a large portion of institutional shareholders’ equities of listed companies in the stock exchange. Investment managers’ significant role in monitoring and holding corporate managers to account was the reason for embarking on the second questionnaire. The next section deals further with the empirical side of this study; in particular, providing details of data collection, research methodology and response rate.

1.7. Data Collection, Research Methodology and Response Rate

1.7.1. Data Collection and Research Methodology

Data from primary legal resources are analysed in discussing the role that institutional shareholders and investment managers could play in monitoring and controlling the corporate management of corporations. The primary sources include statute, mainly the C.A. ’1985 and the common law as developed over the years. Other primary legal resources which are used include: the reforms proposed by the Modern Company Law White Paper (2002), the ‘Codes of Best Practice’ on corporate governance; the Financial Market Regulations; and, the other government departments, commissions and agency reports such as the Higgs Report on improving non-executive directors’ role in holding corporate executive directors to account. Secondary legal resources that are used include: books; articles; conference papers; and, comments that were written or uttered mainly by legal scholars. Comments and feedback by the author’s supervisor Mr. Ian Snaith were also considered and acted upon. The author referred to two other professors for

113 This refers to institutional shareholders and investment managers in their capacity as holders and managers of stocks in the L.S.E.
115 D. Higgs, supra, n 49.
116 Mr Ian Snaith, Senior Lecturer in Law and Nelson Fellow in Law at the University of Leicester Law School.
comments and advice on the questionnaires constructed for this thesis: namely; Professor John Scott\textsuperscript{117} and Professor Larry Hamermesh.\textsuperscript{118}

The reason for embarking on this study (in obtaining empirical evidence through launching the two questionnaires) was the desperate need for such data in this area in the U.K. In commenting on papers written on the role of institutional investors in corporate governance Garrido stated:

> In the field of corporate governance in general, and on the role of institutional investors in particular, empirical studies are much needed and welcome. Our discussions on the economic significance of institutions, or on the legal rules that affect them, should be underpinned by empirical studies that point to the facts behind the rules and the economic models. The problem is the lack of fundamental guidelines for this empirical research.\textsuperscript{119}

Hence, it is important that a lawyer conducts research in this area since work by other disciplines; such as finance or sociology, tend to provide a rather limited discussion to the implication of law in the area of corporate governance. Other disciplines of research would also tend to ignore the very core of corporate governance, which is its legal structure. Indeed and as Garrido affirms above, the author had great difficulty in finding guidelines on empirical research that fits into a legal framework. This was a cause for travelling to the U.S., Jordan and different sites within the U.K. to obtain advice from legal researchers, as well as researchers from other disciplines. The author also attended research methodology workshops and conferences, in order to establish some background on how to obtain and handle empirical evidence.

Obtaining knowledge about empirical research did not particularly offer solutions to the fundamental problem of how to generalise findings. Problems that faced conducting research for this study and which will face future research in this area,

\textsuperscript{117} Professor John Scott from Sussex University, Department of Social Sciences, is a leading expert in shareholders' behaviour in the U.K.

\textsuperscript{118} Professor Larry Hamermesh of Widener Law School, Delaware State, U.S.A. was consulted while the author was a researcher in Widener University in the summer of 2000. The views expressed remain mine alone, as is the responsibility for any errors or omissions.
are also related to validity and reliability. The initial problem faced by the author was the question of who could represent the market. Indeed the answer to this question is that there are many groups to be considered. Furthermore, within a group there can be many subgroups in which each has to be taken into consideration. For example, shareholders as a group of market participants can be divided into 13 subgroups. There are also the employees in a corporation who can be divided into many groups; *prima facia*, junior employees and company managers. Moreover, there are many other internal and external groups. In conjunction to matters concerning representation, there were problems related to sampling, etc. However, after much turmoil over how to confront these issues, it was found that the best method the author could use was grounded theory. The hypothesis of the study was based on this theory although the author was open minded about being proven right or wrong in the process of collecting data.

In consideration of the sample for this study, it would have been very ambitious to examine groups other than shareholders. The appropriateness of pension funds and institutional investors and investment managers within the shareholders group, for the purpose of this research is two-fold: first, it is difficult to gain access to other shareholders subgroups; and second, these two subgroups hold most of institutional investors’ investment in L.S.E. and hence, are thought (at least in theory) to be able to hold corporate managers to account. As mentioned above, the reason for including investment managers is that as well as managing most of the pension funds holdings, they also manage fund for private shareholders and hence, are

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Grounded theory is rapidly gaining momentum in social science research. Yet, there is considerable disagreement among its co-founders; B. Glaser and A. Strauss in *The Discovery of Grounded Theory* (1967); concerning the implementation of this approach, which resulted in some ambiguity concerning the application of the theory. This methodology, however, appears to hold considerable potential for legal research. This is particularly because of its focus on the generation of theory from data collected in the field, which seems ideally suited for lawyers who want to gain further insight about an area which lacks a well-developed theoretical foundation.
thought to hold the key for any effective collective action among shareholder
groups. Professional investors were also asked to input their views, as the author
thought they would provide a sharp insight into what goes on inside the market. In
using grounded theory however, one could only claim to have obtained an insight to
the market and certainly not data on which to make any generalisations.

The fact that institutional investors, particularly those in occupational pension funds,
do not manage their investment has been confirmed in the Myners Report. The
Myners Review found that most occupational pensions are organised on a trust
basis, appointing a board of trustees responsible for determining how the assets are
invested. Despite the fact that trustees determine how the assets are invested, the
Myners Review found that many of those trustees are not experts in investment.
62% of trustees in reality have no professional qualifications in finance or
investment. It was also revealed that even though many trustees did not have
professional qualifications in finance or investment, this did not necessarily lead to
employing in-house professionals to assist them. In fact, 77% of trustees have no in-
house professionals to assist them.\(^\text{121}\) This may be an explanation on why 70.6%\(^\text{122}\)
of institutional investors who participated in this study’s questionnaires do not

\(^{121}\) P. Myners, supra, n 43, at 5.

It is worth noting that any study on institutional investors and their role in monitoring
management would be incomplete if the role of investment managers was abandoned.
See G. Stapledon, 'Disincentives to Activism by Institutional Investors in Listed
Australian Companies', supra, n 68.

Informal conversation with some pension funds showed a high degree of trust
between these pension funds and their external managers, to such an extent that they
would fully submit their equity to these external managers to invest on behalf of
them. It might be argued that this is mainly because some institutional investors lack
the time and the managerial skills to invest in-house.

\(^{122}\) In fact, the institutional shareholders’ questionnaire of this thesis revealed that 87% of
institutional shareholders equities, which are listed in the L.S.E., are delegated to
investment managers to manage. The fact that the figures of those institutional
investors who do not manage any equity portfolio in house and those who delegate
the management of their equities to investment managers, differ, is due to the fact that
some institutional investors delegate only a portion of their equities to investment
managers, rather than their entire holding. The institutional investors’ questionnaire
also showed that a large number of institutional investors, particularly pension funds,
are not at all involved in the management of their equities, let alone holding to
account corporate management. Of those who delegate the management of their stock
exchange listed equities to investment managers, there is a large proportion who only
manage any equity portfolio in house. However, the Myners Review found that larger pension schemes are more likely to recruit and train more knowledgeable trustees.

The first questionnaire was addressed to institutional shareholders; namely; pension funds and insurance companies. Pension funds and insurance companies collectively own a large stake of the U.K. listed equities. The second questionnaire was directed at investment managers, in their capacity as owners of some of the listed shares and as agents of institutional shareholders, mainly pension funds. The method used in constructing the questions had both qualitative and quantitative elements. After a question was asked, multiple-choice answers were provided, from which the respondent could choose. A space for comments was also provided after most questions, allowing respondents to express their own opinions and draw on personal experience, providing any useful comments in a less structured manner. Overall, the study’s approach was chosen to overcome many of the disadvantages of qualitative and quantitative research methods.

An early pilot study was distributed to a small number of investment managers at the Annual Conference of the National Association of Pension Funds in Glasgow on 11 and 12 May 2000. The pilot study was only given to those investment managers who showed interest in participation in that study. In total, 43 investment managers were approached but only 24 were willing to participate in the pilot study. The questionnaire was distributed along with a self-addressed stamped envelope. A reminder was sent to those who were late in replying. The response rate was 37.5%. The data acquired from those investment managers who completed the questionnaire resulted in some changes in the nature and the structure of the questionnaire. The

monitor investment managers’ performance and compare it to other investment managers and the market indices.


124 Researchers normally use the interview approach to enable a richer and more complex picture to emerge. However, one major weakness of such a method is that it is not feasible to survey large numbers. A questionnaire on the other hand is useful in that it enables a large number of respondents to be surveyed. Yet, it does not normally acquire a detailed picture of the issues researched. The author believes that the method used in this research considerably overcomes these obstacles.
final questionnaires were sent out in November 2000, after which, one month was given for respondents to complete the questionnaires and return them. A reminder was sent to those who failed to meet the deadline. The vast majority of those respondents who completed the questionnaires returned them after only a few days of receiving them.\textsuperscript{125} The total period from despatching the first questionnaire to commencing data entry was two months.

\textbf{1.7.2. Response Rate}

The first questionnaire was sent to all the member institutions of the National Association of Pension Funds (N.A.P.F.) and the Association of British Insurers (A.B.I.), (described as such by those organisations, at the time), totalling at 867 institutions. The questionnaire forms (see Appendix (A) with covering letter) were despatched to the Chief Investment Managers or Institution Secretaries, or the equivalent titles by name (where data was available), along side postage-paid, self-addressed envelopes.

The second questionnaire was sent to all investment managers that invest for insurance companies and pension funds (as described at the time by the N.A.P.F. and A.B.I. to be the investment managers that manage shareholdings for their members), totalling at 132 investment managers.\textsuperscript{126} The questionnaire forms (see Appendix (C) with covering letter) were despatched to the Chief Investment Managers or Funds Secretaries, or the equivalent titles, by name, where data was available, along side postage-paid, self-addressed envelopes.

\footnotesize{\begin{itemize}
\item \textsuperscript{125} In the case of investment managers, the reminder did not result in any more questionnaires being returned. The reminder only resulted in about 5\% more of the institutional shareholders' questionnaires being returned.
\item \textsuperscript{126} A list of all outside investment managers used by members of the N.A.P.F. and the A.B.I. was requested from both the N.A.P.F. and A.B.I.'s membership lists. This was received in October 2000.
\end{itemize}}

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Response rates were calculated as follow: Response rate = number of responses (total responses – (ineligible\textsuperscript{127} + unreachable\textsuperscript{128})) divided by (total number in sample – (total of ineligible + unreachable)).

**Institutional Investors sample:** the total number of returns was 231, where 77 refused to co-operate, 39 were classified as ineligible (do not invest in L.S.E.), 13 classified as unreachable (no longer in address). The response rate was 13.82% (102/738[867-39-77-13]).

**Investment Managers Sample:** the total number of returns was 36, where 15 refused to co-operate, 5 were classified as ineligible (do not invest in L.S.E.), 2 classified as unreachable (no longer in address). The response rate was 12.72% (14/110[136-2-5-15]).

Given the length of the questionnaires, the sensitivity of some of the information sought and the value of time of those to whom the questionnaires were directed, the response rate in both questionnaires was pleasing. The detailed response rate is illustrated in Appendix E (Table 1.2 and Table 1.3). The questionnaires were directed to all those institutions about which the author had information. There may have been some institutions, to which the author was unable to send the questionnaires to due to the difficulty of obtaining any information about them. Knowing that some of the questionnaires would inevitably be directed to institutions without any investments in the L.S.E., an initial question on this point was included. If a respondent did not invest in the L.S.E., they were asked to tick a box and return the questionnaire uncompleted.

An initial problem was that some institutions returned the questionnaire uncompleted because of a misunderstanding about the questionnaire. A common confusion was the belief that their institution had to be a public listed company, rather than companies that they invest in, for them to be able to respond. The cause

\textsuperscript{127} The ineligibles are those selected respondents who did not meet the research requirements and could not be included in the analysis.

\textsuperscript{128} The unreachable are those returned by the post office.
of their confusion may have been the title ‘Shareholders Legal Status in Public Listed Companies’. Although the title was chosen to give a clear indication of the subject matter of the questionnaire, it was misunderstood.

The collective size of the institutional investors who completed the questionnaire is £413 billion and their collective investment in L.S.E. as for December 2000 was £194 billion,\(^\text{129}\) £150 billion of which is invested in house and 44 billion invested externally.\(^\text{130}\) It should be noted that despite the fact that the majority of institutional investors number (87%) delegate the management of their equity to external equity managers, it is still just over 29% of the collective equity size of those institutional investors who completed the questionnaire. This is because; large size institutional investors tend to invest in-house. This is logical, considering for example, that it makes economical sense to appoint investment experts to look after funds.

On the other hand, the collective size of shares held and managed by the investment managers who completed the questionnaire is £205 billion, but there was no question in the investment managers’ questionnaire asking about the ratio of investment in the L.S.E. In spite of the large amount of institutional investors and investment managers who participated in this study’s questionnaires, it is important to recognise that it might be problematic to generalise beyond the case study itself. However, the findings of this research may form the basis for further research into the phenomena of institutional investors’ and investment managers’ involvement in U.K. corporate governance.

1.8. Questionnaire Content

The questionnaire can be divided into seven groups of questions.\(^\text{131}\) The first group of questions dealt with: general information on investment policy; the size of the institution and size of the investment in L.S.E.; who manages the stock exchange.

\(^{129}\) This figure accounts for 13% of institutional shareholders’ assets ownership. The actual assets ownership in the said financial year is estimated at 1,500 billion, according to the Myners Review, supra, n 43, at 4.

\(^{130}\) The figures are rounded.

\(^{131}\) Full versions of the questionnaires are in Appendices A and B. The questionnaires sent to investment managers covered the same issues with slightly adapted questions.
portfolios (in the case of institutional shareholders), whether they read the company memorandum and articles of association to establish the level of protection available against management, or use of other sources of information to find out whether or not the company complies with the normal protection for shareholders provided by the Combined Code; and, whether or not investment shareholders use index funds.

The second group of questions examined the relationship between institutional shareholders and their external fund managers. This group of questions aimed to provide insight to the relationships between these various groups, examining the validity of the allegation that institutional shareholders, when they act collectively, can provide protection for themselves and for private shareholders. The initial hypothesis of the author of this thesis was that institutional shareholders can influence management. However, if that is true, one needs to establish whether such influence carries any value for other groups of shareholders, especially individual/private shareholders. Although here, the same questions were not asked of private shareholders, one can argue that if institutional investors are generally of the view that there is a conflict of interests between themselves and individual shareholders, this would indeed support the claim that they are not going to provide any protection for private shareholders.

The third group of questions considered whether or not there is any form of dialogue between institutional shareholders *inter se*. It also examined whether or not there is a relationship between institutional investors and investment managers on one hand and the company management (owner/agent relationship) on the other hand, and if there is one, what is the basis for it. Moreover, other questions in the questionnaire

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132 The significance of the third group of questions is that it shows the basis of the institution’s answers, i.e. whether it is based on experience of what they would like their investment managers to do.

133 This is intended to test the empirical basis of assumptions in corporate governance literature that these documents are somehow directly or indirectly negotiated between shareholders and others involved with the company.

134 There is a hypothesis that there is a strong correlation between investing in index funds and the lack of commitment to monitor and, if necessary, discipline management. This allegation itself is tested in a later question.
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Chapter One

inspected whether or not there is any conflict of interests between these two groups and if there is, what is it and how can it be avoided. What the study lacked here is information on the point of view of company management to enable a comparison to that of shareholders. The fourth group of questions examined the relationship between institutional investors and company management. It also examined whether or not there is any conflict of interests between these two groups and if there is, what is it and how can it be avoided. This set of questions was related to group three of the questions in the questionnaire; ‘the relationship between shareholders inter se’.

The fifth group of questions examined a number of factors which legal scholars suggest as causes for institutional shareholders’ inactivity in monitoring company management. Twelve different reasons were stated in this part of the questionnaire to uncover whether or not these theoretical constraints have any practical basis. The sixth group of questions dealt with whether or not there is a conflict of interests between individual shareholders and institutional shareholders and, if there is, what it is and how can it be avoided.

The seventh group of questions raised matters concerning the policy of investment managers and institutional shareholders when discontented with management and their willingness to use litigation. One of these questions raised the possible action they might take if dissatisfied with management. Seven options were given to institutional investors which they were asked to rank in order of importance (i.e. 1 = most important, 7 = least important). The eighth set of questions examined the use of the voting system as a measure for protecting the interests of shareholders against the interests of management.

As mentioned above, most questions in the questionnaires were tailed with space for the respondents to provide comments about the questions. This is, inter alia, because of the author’s realisation of the importance of having qualitative data. Many respondents used the spaces made available to provide comments. The comments provided can be classified as follows: clarification of an opinion; stressing a point; raising other issues related to the points raised in the questions; and, disagreeing with the wording of some questions. The comments are used throughout the thesis to
illustrate certain points and to refute or prove an argument. Yet, the author is not suggesting that by providing these comments that they could be generalised to the whole market. In fact, the author acknowledges that these comments are not necessarily representative of the view of shareholders, let alone the whole market.

The second questionnaire that was directed to investment managers had similar contents to the institutional investors’ questionnaire, with appropriate alteration and addition to ensure its relevance to this group. It should be mentioned that the questionnaires of this study were particularly inspired in their design, format and to some extent, content, by earlier published work conducted by Zanglein.135

1.9. Conclusions

Corporate governance is not limited to the boundaries of one academic discipline. Lawyers, political scientists, economists and sociologists all have interest in this area. This is because successful corporations are amongst the necessary foundations of a great economic power. Though, in ensuring that the corporate governance system is sound and the Stock Market enjoys its much needed integrity, it is essential to provide a good and sound legal framework. There is no doubt that law is the discipline placed at the heart of corporate governance. In the 1980s and early 1990s, the U.K. Stock Market witnessed a series of spectacular company collapses and failures, although the companies’ previous reports and accounts showed little indication that they were in the final stages of terminal decline. This is what happened for example in, Polly Peck,136 British and Commonwealth, Bank of Credit and Consumer Commerce (B.C.C.I.),137 Brent Walker and Maxwell


136 In the early 1990s, Polly Peck went from being in the F.T.S.E. top 100 into receivership. The receivers could not find misappropriated assets or make sense of the corporate account.

137 BCCI was a bank that thrived on dealings with small enterprises, which meant that a great deal of small enterprises were ruined upon its collapse.
Communications, Parkfield, Coloroll, etc. On the other side of the Atlantic where the legal structure of the Stock Markets are similar to that of the U.K., there are more recent examples of corporations' collapses, such as WorldCom (which admitted to fraud in its accounting), Enron (the energy giant corporation that collapsed in 2001, which has now filed for 'bankruptcy'\(^{139}\) for 'adjusting' its accounts), and Rank Xerox, of which serious accusations of management and auditors misconduct were filed against it.

Supposedly, in both the U.K. and the U.S., there are constraints put in place to hinder corporate managers abusing their power, which also entails a push to perform better. By and large, those constraints can be divided into external and internal constraints, some of which are the subject of great controversy as to whether they could ever actually work.\(^{140}\) As for external constraints on managerial behaviour, one\(^{141}\) could generally divide them into: the capital market; market for corporate control; product markets; and, the managerial labour markets. The internal constraints on the other hand, can be divided into two types of constraints. The first constraint is related to the board of directors, which includes: separation of the position of chief executive managers and the chairman; non-executive directors; executive compensation schemes and committee. The second constraint is related to shareholders, which itself can be divided into: shareholders’ voting; shareholders’ remedies; and, institutional investors’ activism.\(^{142}\)

The corporate governance structure in the U.K. only 'allows' one group of stakeholders (namely; shareholders), to hold corporate managers to account. It is not

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\(^{138}\) Robert Maxwell was the founder of the Maxwell Group who after disappearing, left thousands of U.K. pensioners with insecure financial futures because of his unfair dealings.

\(^{139}\) An American term, similar to that of 'insolvency' in the U.K.

It should be mentioned here that the auditors Arthur Anderson also collapsed in 2002 in the wake of the Enron scandal, upon discovering that they had compromised their independence when dealing with Enron accounts, by providing other services.

\(^{140}\) The source for this division is, D. Smith, 'Corporate Governance and Managerial Incompetence: Lesson from Kmart', (1996) 74 (4), *North Carolina Law Review*, 1037, in particular, at 1110-1128.

\(^{141}\) ibid. at 1038.
yet the case and most likely never will be, for one to suggest including other stakeholders in the equation of the distribution of power in U.K. company law. Yet, the fact that corporate managers are only ‘sufficiently’ accountable to one group of stakeholders; namely shareholders, is still better than being accountable to none. The difficulty of holding corporate managers accountable before shareholders was and still largely is, finding the appropriate method to do so. The approach that is taken in the U.K. is to bridge gaps in the accountability system in large corporations, as set out by company law by various methods. Primarily, as well as the various pieces of legislations such as the Companies Act and Insolvency Act, the U.K. corporate governance framework is supported by the common law standards, Listing Rules and voluntary self-regulated ‘Code of Best Practice’.

The approach taken by the U.K. legislature has been to gradually (though rather very slowly) deal with problems that arise in the corporate governance system, rather than changing the system as a whole. There is a real reluctance in the U.K. legislature to change the existing legal framework of the corporation, distinguishing it from other types of companies. This may be right, in considering that the L.S.E. is a very successful market and thus, major changes to the existing system might be costly, as echoed in the recent Company Law review. Other stakeholder groups in corporations, to some extent, allegedly have the support of various legislations to support their interests, such as employment law, consumer law, environmental law, etc. Though, in terms of interests, the dominating corporation theory still supports by and large, shareholders’ primacy position in U.K. corporations.

British company law does provide the means for shareholders to hold corporate managers to account. However, due to share ownership dispersion, legal scholars were prompted to consider other mechanisms by which corporate managers could be held to account. Yet, after much debate and research and aided by the fact that share ownership is concentrated in the hands of institutional shareholders, legal scholars have come back to the belief that the key to solving the corporate governance problem is still held by shareholders. Not only the work of academics, but also the Government Reviews of Myners and Higgs have placed emphasis on the role that

142 ibid.
could be played by institutional shareholders and investment managers in making the corporate governance system sounder. This is because of the size of institutional shareholders and investment managers’ investment in the L.S.E. The distribution of share ownership shows that ownership and control are no longer inevitably divorced, as was claimed by Berle and Means. The distribution of share ownership, in the U.K. shows that together, institutional shareholders and investment managers, subject to their willingness and free from legal restraints, could control corporations and their managers.

It is clear that investment managers in particular have a major role to play to achieve a more sound corporate governance system in the U.K. This is mainly because of the fact that a large proportion of institutional shareholders literally submit all their investment to be managed by professional external investment managers. The issue of institutional shareholders and investment managers’ ability and willingness to hold corporate managers accountable is the subject matter for discussion throughout this thesis. A brief summary of the findings of this study is provided in the next section, in order to give the reader a clear idea of the issues discussed in the thesis.

1.10. Thesis Executive Summary

In outlining the main protections and legal barriers that affect shareholders’ ability and willingness to monitor corporate management, this thesis found the following:

- Clearly, holding corporate managers accountable to shareholders in large corporations where control and ownership are separated is rather difficult. However, the U.K. legislature is reluctant to provide two different systems: one for large corporations; and the other, for all other companies. This may be because of the success of the L.S.E. and difficulty of providing a system for the former.

- This study supports some of the claims purported by legal scholars of the existence of many financial and behavioural reasons that causes shareholders’ apathy in monitoring and controlling corporate management.
• The U.K. legislature has not depended solely on one theory in creating the legal framework of corporations. It has rather relied on a variety of theories. Clearly, in some areas, company law has applied contractual theory and in other areas, it seems to have applied corporate concession theory. This in part, has created confusion regarding shareholders’ legal status. As a result, shareholders in large corporations cannot be treated as mere ‘owners’, which consequently creates room for corporate managers to go unaccountable.

• Institutional shareholders and investment managers who participated in the questionnaires of this study, make hardly any use of their contractual power with corporations’ controllers to negotiate more protective terms that could be included in the companies’ constitutions. This makes contractual theory almost redundant in large corporations. In fact, most of the institutional shareholders and investment managers, who participated in the questionnaires of this study, hardly read corporations’ constitutions. This is rather surprising, considering the importance of such documents to corporations. Consequently, one might suggest that if this is the position of institutional shareholders and investment managers, who are able to analyse such documentations, the situation would certainly be dire for other types of shareholders (particularly private shareholders) who do not have the expertise to make great use of such documents.

• Using litigation is almost always a redundant method of holding corporations’ managers accountable in the U.K. This is not only because of the vagueness of the statutes and the reluctance of the courts to interfere in running corporations, but also because of the culture in the U.K., of the ‘lack of will’ to litigate.

• Using voting and the proxy system to hold corporate managers accountable is a method that is becoming increasingly important to shareholders in the U.K. Yet, it is still very short of being near effective.

• Using dialogue to monitor and influence corporate managers is vitiated by many problems. Dialogue is definitely over-regulated in the U.K. Hence, more thought should go into establishing how to strike the right balance between avoiding
Part One  Chapter One

market abuse and keeping shareholders involved through dialogue in the governance of corporations.

• Dialogue between shareholders to achieve collective action/coalition building to challenge corporate managers for example, is also over-regulated.
Part One
Chapter Two

The Economic Framework of Monitoring and Holding Corporate Management to Account

2.1. Introduction

The fact that share ownership is concentrated in the hands of major investors (such as institutional investors and investment managers) suggests that shareholders could potentially hold corporate managers to account. This is of course, however, subject to shareholders’ willingness and ability to do so. This chapter examines the former. By and large, investors can be divided into three different categories concerning the monitoring and controlling of corporate managers. These are namely: active investors (i.e., have a policy in place to monitor all investment portfolios and do so continually); inactive investors (i.e., do not have a policy in place to monitor investment portfolios and do not do so); and, potentially active investors (i.e., have a policy in place to monitor all investment portfolios but only do so if it is viable and economically sensible).

If shareholders wish to monitor as a matter of policy, then they would do so regardless of the number of shares that they hold in a company. Indeed, some shareholders do have such a policy. One institutional investor, for example, stated: ‘[c]learly smaller per cent holding = Less impact on portfolio performance. However, we monitor performance of all companies in portfolio.’ Another institutional investors affirmed: ‘[a]ll shareholdings are worth managing to achieve best results.’ However, the importance of having a policy for monitoring should not be overstated. Of course, even active investors might still in certain cases look at the viability of change before committing themselves to monitoring in a corporation. Specifically, it is pointless for investors to bear the cost of monitoring if there is no viability of making corporate governance sounder.

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1 Institutional investors’ questionnaire, control number 104.
2 For example, institutional investors’ questionnaire, control numbers 133 and 234.
Inactive investors usually rely on others to do the monitoring and/or exit, when available. The third type of investors, which could arguably be the majority of shareholders, whether private or institutional, may wish to monitor management but are deterred from monitoring because of the cost of doing so. This is known to be a form of the agency problem of corporations. Most shareholders, including institutional investors and investment managers, do not have the weight as individual shareholders (i.e., when not acting in concert with other shareholders) to monitor and hold corporate managers to account in order to achieve a sounder corporate governance. Hence, for viable monitoring, collective action between shareholders is needed. The reasons that affect collective action among shareholders are discussed in chapter six of this thesis. This chapter however, principally focuses on institutional investors’ and investment managers’ attitudes towards reasons that allegedly affect the third type of investors who have a policy in place to monitor and control corporate managers on the condition that it is economical to do so.

The dilemma therefore, that some shareholders may face when considering monitoring corporate managers is whether it makes economic sense to do so. For some shareholders, it might be a matter of the size of their stake and whether it is worth making an effort to make the corporate governance system within the company which they invest, sounder. For such shareholders, at times but not as a matter of policy, selling shares may be the easiest option.\(^3\) The equation for this type of investor may sometimes be as simple as: is the expected added value greater than the potential cost? If so, only then, would monitoring be exploited.

It should be highlighted that the empirical data of this study revealed that some institutional investors, especially those who employ external equity managers, think that investment managers should monitor corporate managers. One institutional investor for instance, stated, ‘[i]nvestment managers should monitor each and every [company]… it is their primary function.’\(^4\) However, the problem that might arise

\(^{3}\) Institutional investors’ questionnaire, control number 38, stated: ‘[s]maller shareholders are more likely simply to switch investment if dissatisfied.’

\(^{4}\) Institutional investors’ questionnaire, control number 3.
from the latter approach is that the agency cost of monitoring might be passed from one agent to another, (i.e., from corporate managers to investment managers). This is because, when those institutional investors rely completely on their external investment managers to monitor corporate managers, there should be a mechanism put in place to make sure that investment managers are actually delivering what institutional investors want them to deliver. Such a mechanism should always underpin what is asked by institutional investors to be delivered, in conjunction with what is actually delivered. Furthermore, reliance on external investment managers should not be based on a vacuum. There should be a monitoring policy put in place by institutional investors on how and what to monitor, which could then be directed to external investment managers to be implemented. After which, institutional investors should monitor what external investment managers have achieved so far as monitoring and controlling corporate managers is concerned.

2.2. Objectives

The objectives of this chapter are to introduce some aspects of investors' behaviour in the U.K. equity market, particularly in relation to investors' willingness to monitor and be involved in corporate governance matters, which mostly apply to the type of investors that have the potential to monitor corporate managers, but because of certain factors, decide not to monitor. The new evidence as exposed in this chapter has its consequences for existing research on the influence of legal aspects of institutional investors and investment managers. It is the view of this study that it is not only the ownership structure that is important in the monitoring capacity of the different types of shareholders, but also, the economic framework and its influence on shareholders behaviour. This chapter therefore reflects on the interaction between law, sociology and economics. Though, and as mentioned in chapter one, concerning the methodology of this thesis, statistics provided in this chapter are indicative and are only meant to give an insight (rather than to make generalisations) as to what goes on in the market.
2.3. Possible Reasons for Investors' Unwillingness to Monitor Corporate Managers

This chapter considers the twelve reasons as suggested by Coffee and other legal scholars in relation to what might cause investors to be inactive. They are: thin equity; diversification; liquidity of shares; reliance on other investors; apathy of shareholders' agents; keeping access to soft information; comparison with other investment managers' performance and market indices; conflict of interests; short termism; corporate managers' manipulation of the general meeting's agenda; political retaliation; and, investing in index funds. These possible reasons for apathy in monitoring corporate managers are the subject matter for discussion under the next thirteen subsections. The approach used in this study in examining these alleged reasons was to ask both groups (institutional investors and investment managers) through the executed questionnaires, whether or not they thought each of these alleged reasons affects investors' willingness to monitor corporations and their managers.

In testing whether the suggested reasons affect investors' willingness in monitoring corporate managers or not, this study applies a simple statistical test using percentages. The author argues that applying other more advanced statistical testing is not appropriate for this study. For example, the author considered applying a test of the significance of percentages, yet realised that this study is not the place to contend that for arguments sake, for example, 45% is significant and 39% is not. As far as this thesis is concerned, the fact that there are investors that believed in a reason to affect their ability to monitor and control corporate managers, makes it significant enough to be mentioned. In fact, this goes in harmony with legal research in general, where there is interest in a case study, i.e., legal researchers sometimes pursue a case despite its limited application (being the minority), where the law failed to deliver justice. Nonetheless, it should be noted that this thesis argues that the higher the percentage, the more credible the reason.

2.3.1. Thin Equity

In this study, thin equity was considered to be when a shareholder's holding of a company was less than 3%. The question that was asked to both institutional investors and investment managers was, 'do you think thin equity (i.e. when the holding is less than 3%) might be a reason for investment managers' and shareholders' inactivity in monitoring corporations and their managers?'

In actual fact, there is no agreement on what thin equity is. This is due to the fact that there are many factors which could be taken into consideration when deciding what is considered to be a significant holding. One factor is the size of the company in which shareholders invest. If the company is small, some institutional investors would probably not consider 3% as a significant element in their portfolio. Another factor is the size of the investor's stock portfolio. If an investor holds large funds in its portfolio then, 3% in most of small to medium size companies is probably not a significant proportion of the total portfolio holdings. However, this study selected 3%, not only because it is the point at which the law treats a shareholder as having a notifiable interest in a public company, but also because it might represent the average in which shareholders consider their shareholdings as significant. This choice was supported by the fact that there was not a large disagreement with the figure of 3% as a significant holding, among those institutional investors and investment managers that participated in the questionnaires of this thesis. For example, only one investment manager disagreed with the proposed 3% threshold of investment as a significant holding.

One could argue that the more significant the holding, the stronger the motivation for activity in monitoring corporations and their managers. It is logical to expect

6 There is also no consensus as to what constitutes a small investor. However, it is irrelevant to elaborate on such a debate here, as the point in highlighting such a division is merely to illustrate the differences in opinion regarding the definition of thin equity.

7 Section 199 of the C.A. '1985.

8 One investment manager thought that shareholdings become significant at a higher level of 5-10%. However, among both groups, i.e. institutional investors and investment managers, the vast majority of the respondents did not have any objection to the percentage of 3% as a threshold to distinguish between significant and insignificant holdings.
such a tendency for two reasons. First, the level of impact on corporate governance issues increases as the size of the holding increases and, if corporate managers are not going to listen to shareholders anyway, then there would be no reason to invest in monitoring corporations and their managers; and second, if a shareholder’s holding was insignificant, it might be easier to sell it. Before moving onto testing thin equity, the author examines whether it is possible to exit a company without great loss when shareholdings are at 3% or more.\(^9\)

It is not easy for shareholders and investment managers that hold significant shareholdings to sell without loss, regardless to the size of the listed company itself. However, it may be even more difficult to sell without losses in a large capital sized listed company such as those in the F.T.S.E. 100 and hence, the bigger the investment and the larger the corporate capital size, the bigger the risk of experiencing a loss when disposing of that investment.\(^10\) The counter argument is that some investors would like to buy (for strategic purposes and not least so that they would have a voice) in big quantity, which might make a significant holding more valuable in case of a takeover, for example. That of course depends on the situation. This is rather unlikely to happen if shareholders are dissatisfied with company performance itself, rather than the management or its strategy. For example, one shareholder stated: ‘[d]ifficult to move large shareholding unless the company shares are in demand in which case investor unlikely to be dissatisfied with corporate managers’.\(^11\) This quote suggests that there is also a correlation between the liquidity of shares and being able to sell without a loss.\(^12\)

\(^9\) It should be stated however, that there are two limitations to this question. First, 3% can be a massive shareholding if such a holding is for example, in the top hundred F.T.S.E. companies. Second, the question was rather open to respondents’ interpretations to what a great loss means. However, it gives an indication of the availability of the option of exiting troubled companies.

\(^10\) Investment managers’ questionnaire, control number 222, thought that one needs to give a discount when selling significant holdings. The example given was: ‘... a 4% holding might need to be sold at a 4% discount to the best bid’.

\(^11\) Institutional investors’ questionnaire, control number 38. Institutional investors’ questionnaire, control number 160, made the point that: ‘[i]t depends on how much over 3% holding is and how many other large holders have the same mind.’

\(^12\) Six institutional investors and two investment managers linked exiting the company at a significant level without a great loss to the liquidity of the company’s shares. Institutional investors’ questionnaire, control numbers 146, 298, 587, 589 and
It is conceivable however, that shareholders would use marketing techniques to sell their shares if they knew or even suspected that a problem in the company was imminent. One of those techniques is to distribute the selling of shares into small parcels over a period of time. One institutional investor stated ‘[w]ill need to spread the sell over time to avoid loss.’ \(^{13}\) In attempting to gain a more in depth understanding about what happens in the market concerning selling without a loss, institutional investors and investment managers were asked how often they had the option of exiting the company without great loss, if they were dissatisfied with corporate managers, when they held 3% or more of the company’s shares.

It should be noted that this question was subject to two conditions. First, whether the loss is a ‘great loss’, which was left to the subjective view of the respondents’ as to what can be defined as a ‘great loss’; and second, whether a respondent is dissatisfied with corporate management i.e., the belief that corporate managers are not running the corporation well. \(^{14}\) Frequencies between ‘frequently’ and ‘never’ were chosen as a multiple choice for respondents’ answers to this question, since selling without great loss would vary depending on the situation.

Table 2.1 (Appendix F) shows that the vast majority of institutional investors believe that exiting the company without great loss if dissatisfied with corporate managers is ‘frequently’, ‘occasionally’ or ‘rarely’ a possibility, depending on the

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13 Institutional investors’ questionnaire, control number 378. Another institutional investor (Institutional investors’ questionnaire, control number 320) similarly said: ‘[s]ometimes over time, but this is the advantage of quotation.’

14 The reason for not being precise in defining what constitutes a ‘great loss’ is because there is no agreed definition. This is because, share price is naturally more volatile than for example, the property market where it is easier to identify what is the difference between a loss and a great loss. The wording of the question limited loss to ‘great loss’ to avoid diverting respondents to include insignificant loss.

The influence of liquidity on shareholders’ activity is discussed later in this section.
circumstances. 60.8% believed that this possibility occurs frequently or occasionally. Just 2% believed that such a possibility for selling shares when dissatisfied with corporate managers never occurs. Given the fact that the question used the wording ‘great loss’ the fact that over 53.9% of institutional shareholders thought that the possibility of exiting without a great loss only occurs either occasionally or rarely, seems significant. The results of the investment managers’ questionnaire were almost identical to the results of the institutional investors’ questionnaire. Table 2.2 (Appendix F) shows that all investment managers believed that exiting the company without great loss if dissatisfied with corporate managers is a possibility that occurs, depending on circumstances, frequently, occasionally or rarely. 71.5% believed that the possibility occurs frequently or occasionally.

After discussing the frequency with which shareholders believe they can sell shares without great loss, the discussion now turns to thin equity. Institutional investors and investment managers were asked whether thin equity is a reason for inactivity in monitoring companies’ managers. Table 2.3 (Appendix F) shows that 41.2%, thought that thin equity is a reason for institutional investors’ and shareholders’ inactivity in monitoring companies’ managers. 35.3% of institutional investors thought that thin equity is not an issue when considering monitoring the company and 16.7% were not sure.

The response of investment managers was very different, however. Table 2.4 (Appendix F) shows that the vast majority of investment managers, (57.1%), thought thin equity is not a reason for inactivity. Just 14.3% thought that thin equity is a reason for inactivity in monitoring corporations and their managers. There were no comments made by respondents to help explain why the results in the two groups’ answers were so different and particularly, why the majority of investment managers do not see thin equity as a reason that affects monitoring. One can argue however, that this might be due to the fact that more investment managers take the issue of monitoring as a firm policy. Another reason might be because investment managers are expected to monitor by their clients (those who employ them as external equity managers). Additionally, it is logical to assume that an investment manager would have bigger investment to manage in a particular listed company than a usual
institutional investor. This is because investment managers would normally have combined holdings for different clients in any particular company.

2.3.2. Liquidity of Shares

It might be true as Van der Elst stated that, ‘[t]he U.K. stock market is a very liquid market’. Stakes larger than 5% only count for 14.4%.'\textsuperscript{15} Despite this fact, the author would question the previous statement on two points: first, whether one could generalise that the figure of 5% is rather high in the British stock market; and second, that the statement fails to distinguish between thin equity and liquidity. Yet, it is still necessary to examine the effects of liquidity on the monitoring of corporations and their managers by investors.

On occasions, institutional investors and investment managers need share liquidity\textsuperscript{16} to meet the demands of their business. Some institutional investors need liquidity of shares more that others, due to the differing nature of institutional investors' various types of business. Traditionally for example, British pension funds were thought to have been the least demanding institutional investors for liquidity of shares. This is arguably due to the fact that most pension funds in the U.K. were newly established in the 1980s and beginning of the 1990s, and were still at the time, receiving much more money from their clients than they were paying out. Recently, this trend has changed. This has been in response to the structural change in the pension market; specifically, paying more money to pensioners when compared to the past. Moreover, this has been due to changes in the law, \textit{inter alia} the 1995 reform.\textsuperscript{17} The figures suggest a constant decline in pension funds' ownership of shares in the L.S.E.\textsuperscript{18}

\begin{itemize}
\item \textsuperscript{16} i.e., not being committed to continue holding shares in a company.
\item \textsuperscript{17} C. Van der Elst., supra, n 15, at 28.
\item \textsuperscript{18} See Table 1.1, entitled 'Beneficial for British Ordinary Listed Shares', in chapter one of this thesis
\end{itemize}
Liquidity of shares is thought to be a reason for inactive monitoring among shareholders and investment managers. Some might have a prime interest in return rather than operational changes in the company. If so, then liquidity of shares would make selling shares achievable. This is because as one investment manager put it, '[s]elling is a trouble free way of escaping time consuming corporate governance issues.' Furthermore, it has been suggested that shareholders would look at the liquidity of a company’s shares, before committing themselves to significant holdings of 3% or more. Yet, there are shareholders who believe in monitoring as a policy, regardless to whether or not the shares are liquid.

Institutional investors and investment managers were asked whether liquidity is a reason for inactivity in monitoring corporations and their managers. Table 2.5 (Appendix F) shows that 38.2% of institutional investors considered liquidity of shares as a factor that deters investment managers and themselves from monitoring corporations and their managers, while 40.2% believed that liquidity of shares is not a factor that results in the inactivity of monitoring corporations and their managers.

The results from the investment manager’s group, however, were different. Table 2.6 (Appendix F) shows that a majority of 57.1% of investment managers believed liquidity of shares to be a reason for shareholders’ and investment managers’ inactivity in monitoring corporations and their managers, while 42.9% of investment managers believed that liquidity of shares is not a reason for investors’ apathy. It shows that, while some investment managers (if they are locked in the company) may monitor, it is not investment managers’ prime objective to monitor corporations and their managers. As one investment manager stated, ‘[i]nvestment corporate managers is difficult and highly competitive – monitoring corporate managers is quite a long way down our list of priorities’.

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19 Investment managers’ questionnaire, control number 121.
20 Institutional investors’ questionnaire, control number 146: ‘[w]e would only build up a large shareholding in a company if the secondary target was sufficiently liquid.’
21 Investment managers’ questionnaire, control number 222.
### 2.3.3. Diversification

Investment diversification is a widely accepted notion in reducing risk. This method of investment is widely used by risk-averse investors. The belief held is that the greater number of securities, the lower the risk. However, unlike venture capitalist investors, investors who adopt diversification as a method to reduce risk would have less concentrated shareholdings and thus, less power. It can also be argued that the greater the diversification of shareholdings, the more difficult it is to keep track of both share performance and corporate managers. Yet, as mentioned previously, shareholders might still be active in monitoring corporations and their managers as a matter of policy. Investment managers and institutional investors were asked through the executed questionnaires whether diversification is a reason for inactivity in monitoring corporations and their managers, to examine the common trends in the L.S.E.

Table 2.7 (Appendix F) illustrates almost evenly distributed answers between those institutional investors who agreed and those who disagreed that diversification of investment might be a reason for inactivity in monitoring corporations and their managers. 40.2% of institutional investors believed that diversification of investment might be a reason for inactivity in monitoring corporations and their managers and 36.3% thought that diversification of investment might not be a reason for inactivity. The results in the investment managers' group were different. Table 2.8 (Appendix F) displays that a majority of 57.1% of investment managers deemed diversification of investment not to be a reason for inactivity in monitoring corporations and their managers, while only 35.7% thought that it is a reason for apathy in monitoring corporations and their managers.

Again, there were no comments to offer an explanation for the dissimilarity in position between the two groups. A very interesting point that one can raise by looking at Tables 2.5 and 2.7 (Appendix F) is that institutional investors were almost consistent in perceiving diversification and liquidity of shares as reasons for inactivity in monitoring corporations and their managers. However, the results of the

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investment managers’ questionnaires were the opposite. Tables 2.6 and 2.8 (Appendix F) show that while 57.1% of investment managers thought that liquidity of shares is a reason for apathy, the same percentage of 57.1% thought that diversification is not a reason for apathy in monitoring corporations and their managers.

It is worth noting that the responses given by investment managers are close to their responses in answering the question related to thin equity (see, Table 2.4 Appendix F). Here, institutional investors’ responses to the issue of diversification were also very similar to their responses to the question concerning thin equity (Tables 2.3 and 2.7, Appendix F). Of course, there is an obvious link between diversification and thin equity i.e., both reflect on investors’ perception of risk and serve the purpose of spreading investments to minimise risk.

2.3.4. Reliance on Others in Monitoring Corporations and their Managers

Reliance on others to monitor corporations and their managers can take three forms. The first form is when investors or investment managers that hold equity in a company rely on other investors or investment managers to monitor corporate managers. This is called ‘free riding’. The second form is when shareholders or investment managers rely on other organisations such as the N.A.P.F. or A.B.I. to monitor corporate managers. Finally, the third form is when investors rely on their external investment managers to monitor corporate managers. As far as corporate

23 The problem of free-riding can be illustrated by a comment made by the institutional investors’ questionnaire, control number 587, which reads: ‘[b]ut it shouldn’t be. The top 20 shareholders still tend to hold 80% or so of the company economic value.’


25 The second and third forms of reliance upon others to monitor corporate managers, differ from the first form of reliance, in the sense that there is normally an agreement explicit or implied between the clients/members and the organisation that performs such a duty. Furthermore, the second and third types of reliance differ from each other in the sense that market participants are likely to rely on an organisation to perform monitoring in relation to a specific issue, such as for investors to rely on the N.A.P.F., to monitor corporate compliance with corporate social responsibly. On the other hand, investors who employ external equity managers can draft a contract, passing the whole issue of monitoring corporations and their managers to external equity managers.
governance is concerned, the problem that could arise from any of the above three forms of reliance on others is that it might lead to some corporate managers going unmonitored. However, there is no doubt that as far as achieving good corporate governance is concerned, the worst form of reliance on others to the monitoring corporate managers is free riding.

There could be many reasons for the free riding phenomenon. The most important reason however, is the cost of monitoring (agency cost), as free riding might cut cost in the short term. Moreover, the trustees of investment managers and institutional investors might themselves be judged on a short term basis. Hence, trustees might also resort to short term solutions, including avoiding monitoring in the hope that others would do it.

Of course, and related to agency cost, lack of resources could be a reason for relying on others to monitor corporations and their managers. For example, institutional investors' questionnaire, control number 38 stated: '[l]ack of time. Everyone is working flat out and inevitably some things have to be dealt with superficially rather than in depth.' This is one of the demerits of diversification. This is because it would be hard for institutional investors to monitor a large number of corporations, when they have limited resources. Another institutional investor affirmed: '[o]rganizations must have a very significant resource to effectively monitor all companies and this is costly.' Not many institutional investors and investment managers could actually bear the cost of monitoring corporations and their managers across the wide range of companies represented in their portfolios. Nevertheless, not all institutional investors and investment managers that can bear the cost of monitoring are willing to take on a cost that will reflect on their performance when compared to market

26 Institutional investors' questionnaire, control number 100.

Institutional investors' questionnaire, control number 343, was very precise, stating: '[i]n my case, inadequacy in the investment department (of one person!).'

27 Institutional investors' questionnaire, control number 320, said: '[l]eave it to other 'active' shareholders. Few IM's have the resources to do this effectively.'
indices. Other institutional investors and investment managers though despite these obstacles, are committed to taking an active role in monitoring corporations and their managers as a matter of policy.

In order to determine whether institutional investors’ and investment managers’ activity in monitoring corporations and their managers is affected by free riding, institutional investors and investment managers were asked whether reliance on other shareholders or investment managers is a reason for investment managers’ and shareholders’ inactivity in monitoring corporations and their managers. The results varied tremendously between the two groups. Table 2.10 (Appendix F) shows that 57.1% of investment managers thought that reliance on others could be a reason for inactivity. Yet, according to Table 2.9 (Appendix F) just 37.3% of institutional investors thought that free riding is a reason for inactivity. However, that is not to suggest that institutional investors are more proactive than investment managers. Actually, some of the institutional investors’ comments on this question suggest that they perceived the issue of monitoring corporations and their managers as a battle for investment managers to fight and that, if reliance on others exists as a reason for apathy in monitoring, then it exists among investment managers only. For example, one institutional investor said, ‘[s]ome fund managers better equipped than others (e.g. resources) to initiate corporate managers changes.’ Such a comment clearly indicates that the respondent (an institutional investor) believed that monitoring rests in the hands of investment managers.

Comparing Table 2.9 (Appendix F) with the previous results from the institutional investors’ questionnaire, reveals that they are still consistent in providing similar figures for all the reasons mentioned so far that may affect investors’ willingness to monitor corporations and their managers. Table 2.10 (Appendix F) divulges that the responses from investment managers here are identical to their responses on

28 Comparing with others and market indices is the subject matter of discussion under the next heading, as another factor that might affect investors’ willingness to monitor corporate managers.

29 It should be noted that the question did not include relying on other organisations such as the N.A.P.F. and A.B.I. The results might have been different if such an option was included.

30 Institutional investors’ questionnaire, control number 104.
liquidity. So, as far as the investment managers in this study were concerned, there is a possible correlation between liquidity of shares and reliance on others to monitor (Tables 2.6 and 2.10, Appendix F). There is also a possible correlation in the investment managers’ group between thin equity and diversification (Tables 2.4 and 2.8, Appendix F).

2.3.5. Comparison with Other Investors

The issue of reliance on others to monitor corporate managers, particularly free riding, could be linked to comparison with the performance of other investment managers and market indices. Comparison with other investments means that institutional investors and investment managers might not be willing to monitor corporations and their managers when the price of monitoring reflects on their performance, compared with other institutions and investment managers and the market indices. Thus, the decision for investment managers and institutional investors is not whether monitoring corporations and their managers is beneficial for them. It is rather whether to bear solely the cost of monitoring, while benefiting others who are not contributing towards agency cost by gaining a cost free ride, yet improving performance as a result of the monitoring which has taken place. Thus, those who bear the cost of monitoring might be disadvantaged, compared with the rest of investors.

In a simple case, the equation of comparison with other investors and the motive for monitoring would usually be (the benefits gained from monitoring, subtract the cost of monitoring). The equation could be demonstrated by the following example (though this example could also be used to demonstrate other possible reason that economically affect monitoring, such as thin equity): if for argument’s sake, the benefits drawn from the cost of monitoring are 10p per share, when the cost of monitoring is 5p per share, then an investor that owns 1000 shares in a company should be £100 better off. However, the investor who has born the cost of monitoring, assuming he/she owns 1000 shares, will only be £50 better off. Hence, although everyone is better off, compared with others who did not bear any cost of

31 Yet, the equation could be much more complicated than this.
monitoring, the investor who took the initiative to monitor gained less than his/her inactive counterpart. This is particularly an issue for institutional investors and investment managers, since their clients would compare their performance to others in the same sector, with the potential of replacing them with those who perform better.

Notwithstanding this, some shareholders might be at an advantage monitoring anyway, even if they individually bear the monitoring cost. This is particularly the case when investors hold a large stack in a corporation. This could be demonstrated by the following example: if for arguments sake, the benefits drawn from the cost of monitoring are 10p per share, when the cost of monitoring is 5p per share, then an investor that owns 100 shares in a company should be £10 better off. However, the investor who bears the cost of monitoring, assuming he/she owns 1,000,000 shares, should be at a £50,000 advantage. Hence, the performance of such an investor would be much better compared to the rest of the market including inactive shareholders. Thus, monitoring in such a case is worthwhile. In establishing the views held by investment managers and institutional investors on this issue, the following question was asked of them: Do you think that comparison with other investment managers' performance and market indices might be a reason for inactivity in monitoring companies' managers?

As Tables 2.11 and 2.12 (Appendix F) suggest, the majority of the respondents of both groups did not consider comparison with other investment managers' performance and market indices to be a reason for inactivity in monitoring corporations and their managers. Specifically, 65.7% of institutional investors and 57.1% of investment managers perceived comparison with other investment managers' performance and market indices not to be a reason for apathy in monitoring. 28.6% of investment managers and 18.6% of institutional investors thought that comparisons with other investment managers' performance and market indices were reasons for inactivity in monitoring companies' managers.

32 Monitoring is not always linked to better market value performance. It might be linked to a policy preference to implement socially responsible investment.
It is interesting that responses dropped dramatically. For example, institutional investors response rate dropped from around an average of 40%, agreeing with the reasons provided, to less than 20%. Comments on this question reveal that the reasons for the dramatic drop: for example, four institutional investors and two investment managers stated that comparison is a reason for active monitoring rather that the reverse. One institutional investor said that the effect of comparison is, ‘[r]ather the reverse – performance measurement implies significant monitoring of companies’ is necessary’. These are very interesting comments in the sense that some investors see an even better potential in monitoring as opposed to free riding. Hence, what is interesting and a rather unexpected finding, is that some investors see comparison with other investment managers' performance and market indices as an actual incentive for monitoring. One could deduce from this that some investors do greatly believe in the effectiveness of monitoring and its ability to produce better corporation performance.

2.3.6. Agent's Apathy

This reason is of particular importance as around 87% of institutional investors who completed the questionnaire in this study employ external equity managers. It is specifically important to try to deduce some insight to how institutional investors perceive their agents who are given the job of monitoring corporations and their managers. The issue of whether investment managers are generally apathetic or not, needs much deeper analysis than a single question about it provides. However, the author decided to ask both investment managers and institutional investors whether investment managers as agents for institutional investors are inactive in monitoring corporate performance, assuming that, if investment managers were inactive in monitoring corporate performance, then they would also be inactive in monitoring corporations and their managers.

33 Institutional investors' questionnaire, control numbers 3, 104 and 587, and investment managers' questionnaire, control numbers 126 and deleted number.

34 Institutional investors' questionnaire, control number 3.
The initial expectation was that there would be a low percentage of institutional investors who thought that investment managers were inactive. Moreover, the author expected that even a smaller number of investment managers would believe that investment managers are apathetic in monitoring corporate performance. It was a surprise, however, that the largest group of institutional investors (38.2%) (Table 2.13, Appendix F) regarded agents’ apathy as a reason for inactive monitoring of corporate performance. Only 24.5% of institutional investors did not regard agents’ apathy as a reason for inactive monitoring of corporate performance and 33.3% were unsure. Hence, despite the fact that the vast majority of institutional investors employ external investment managers, a majority of about three quarters of them still either believed that agent apathy is a reason that might lead to inactivity in monitoring corporations and their managers, or were unsure about the issue. This finding is rather surprising and needs further investigation.

The results (not unexpectedly), extracted from the investment managers’ questionnaires were rather the reverse. The largest group of investment managers (42.9%) thought that agent’s apathy was not a reason for inactivity in monitoring corporations and their managers. A minority of 28.6% of investment managers agreed that agent apathy was a cause for inactivity in monitoring company managers (Table 2.14, Appendix F). However, although the minority of 28.6% agreed that agent’s apathy was a cause for inactivity in monitoring company managers, it is an extremely significant figure considering that it was a view taken by investment managers themselves. This is because such a response implies that the investment managers who answered the questionnaires either perceived themselves or some of their competitors as not performing to a high standard. Yet, in saying that, the sample of investment managers who answered the questionnaires is too small to make generalisations from their responses and therefore further research in this area is greatly needed.

35 Obviously, not all investment managers understood this question. Two institutional investors expressed that they did not understand the question (Institutional investors’ questionnaires, control numbers 104 and 418).

36 Further elaboration on the experience of institutional investors with some forms of agents and how they deal with them when problems arise, is discussed in chapters five and six of this thesis.
2.3.7. Demand for Soft Information

Legal scholars such as Black and Coffee\textsuperscript{37} have speculated on the willingness of institutional investors in keeping a ‘cosy’ relationship to maintain the flow of soft information that corporate managers provide to ‘friendly’ shareholders.\textsuperscript{38} In the U.K., corporate managers can only provide soft information to shareholders in, as one institutional investor describes it, ‘non-central areas (e.g. SRI\textsuperscript{39} matters)’.\textsuperscript{40} This is because, corporate managers may otherwise be considered in breach of the Listing Rules if they disclose any price sensitive information before it is made public.\textsuperscript{41} Monitoring needs information. However, published information as required by the Listing Rules Continuing Obligations, is thought to be limited in the information it offers. Hence, soft information might indeed be needed to clarify a public announcement for example.\textsuperscript{42}

It should be noted that some investment managers and institutional investors may have rightly misunderstood the question. This is because asking for soft information in itself is definitely a form of monitoring. It is therefore not surprising that one shareholder stated, ‘[s]uch information is important but not a reason for inactive monitoring.’\textsuperscript{43} It is ‘[...] part of monitoring process! Most companies would not ‘cold shoulder’ fund managers – not in own interests.’\textsuperscript{44} In evaluating this question, one might suggest that it should have been rephrased. It is fair comment to say that asking for soft information is in itself a form of monitoring. However, in conjunction with speculations made by legal scholars, this particular question in the


\textsuperscript{38} The meaning of soft information, alongside other related issues, are discussed in further depth in chapter six of this thesis.

\textsuperscript{39} An abbreviation for socially responsible investment.

\textsuperscript{40} Investment managers’ questionnaire, control number 222.

\textsuperscript{41} See chapter six of this thesis which discusses the issue of soft information in greater depth.

\textsuperscript{42} The issue of what is allowed to be published, to whom and when, is also discussed in greater depth in chapter six of this thesis.

\textsuperscript{43} Institutional investors’ questionnaire, control number 431.

\textsuperscript{44} Institutional investors’ questionnaire, control number 587.
questionnaires rather meant, whether institutional investors' and investment managers' desire to maintain friendly relations with corporate managers, could be a deterrent on taking more drastic action in attempting to restrain corporate managers' power. However, due to the fact that there were many comments made by respondents to suggest confusion with regards to the question, one might suggest that most investors understood the question to mean; do investors trade off soft information with other means of monitoring, as opposed to using more than one form of monitoring. Notwithstanding the confusion that this question might have caused to respondents, the results of this question were very interesting.

Although, as Table 2.16 (Appendix F) suggests, a clear majority of 57.1% of investment managers did not believe that keeping access to soft information through friendly relations with corporate managers is a reason for inactive monitoring of corporate performance, still, 35.7% thought it was a reason for inactive monitoring. These results came as a surprise, especially since they were extracted from the responses of the investment managers' group. The results of the institutional investors' questionnaire were however, different, with a lower percentage believing that keeping access to soft information is a deterrent on monitoring. Specifically, as Table 2.15 (Appendix F) reveals, only 18.6% of institutional investors thought that keeping access to soft information through friendly relations with corporate managers is a reason for the inactive monitoring of corporate performance. However, the largest group (47.1%) of institutional investor respondents (Table 2.15 Appendix F) thought that keeping access to soft information through friendly relations with corporate managers is not a reason for the inactive monitoring of corporate performance, while 33.3% were unsure.

2.3.8. Conflict of Interests

One could allege that institutional investors generally, but particularly insurance companies and banks, could be '[...] shy of in criticising PLC's who give their company work.'

On the other hand, there are '[u]usually arms length relationships

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45 Institutional investors' questionnaire, control number 359.
between [an] investment manager subsidiary and [its] parent. At least in theory, 
"[...] companies will seek to keep the two sides separate and judge each on its 
merits." The issue of a conflict of interests is discussed in further depth in chapter 
six of this thesis. The concern here however, is to discuss whether institutional 
investors and investment managers perceive a conflict of interests as a reason that 
might affect monitoring corporations and their managers. In order to determine 
whether a conflict of interests poses a threat to shareholders' activity in monitoring 
corporate managers' and corporations' performance, institutional investors and 
investment managers were asked the following question: do you think that a conflict 
of interests, such as the fear that insurance companies or banks may lose their 
business with the company in which they have shareholdings, might be a reason for 
shareholders' inactivity in monitoring the corporate managers?

Tables 2.17 and 2.18 (Appendix F) demonstrate very similar results from both 
institutional investors and investment managers in relation to the effects of a conflict 
of interests in monitoring corporations and their managers. Around half of the 
respondents from both groups did not think that a conflict of interests is a reason for 
shareholders' inactivity in monitoring the company's managers. 35.7% of 
investment managers and 30.4% of institutional investors believed a conflict of 
interests to be a reason for shareholders' inactivity in monitoring the company's 
managers.

One would argue that the fact that 35.7% of investment managers and 30.4% of 
institutional investors believed a conflict of interests is a reason for shareholders' 
inactivity in monitoring company managers is rather significant. This is because at 
least in theory, the conflict of interests described in the question should not exist

46 Institutional investors' questionnaire, control number 277.
47 Institutional investors' questionnaire, control number 38.
48 The issue of a conflict of interests between various groups of investors is discussed 
further in chapter six of this thesis with specific reference to investors and corporate 
managers. Furthermore, the issue of applying measures to avoid a conflict of interests 
is also discussed in more depth in this chapter.
Part One  Chapter Two

because of the application of the ‘Chinese Walls’ method\textsuperscript{49} and the legal and moral responsibility of institutional investors and investment managers to act in the best interests of their trustees and beneficiaries. The fact that such a significant amount of investment managers and institutional investors in the study held this belief makes this area worthy of further discussion and research.

2.3.9. Short Termism

The expression ‘short termism’ is somewhat rather vague and there does not yet seem to be a consensus on what it means.\textsuperscript{50} Furthermore, there is no conclusive empirical evidence to support or refute the proposition that short termism affects investors’ willingness to monitor corporate managers. In fact, there is conflicting empirical evidence as to whether short term investment has a negative or positive impact on corporate performance.\textsuperscript{51} For this thesis, however, short termism is defined as being the opposite of ‘long termism’.

This thesis views long termism as that which encompasses investors’ commitments to buy and hold reasonably significant blocks of a corporation’s shares. Hence, short termism occurs when an investor is not committed to holding acquired shares. This definition brings about the ‘relational investment’ debate, which simply means that in order for shareholders to be active in monitoring management they must have the commitment to buy a significant holding in a corporation.\textsuperscript{52} Indeed, the particular importance of long term investors to corporate managers is that such an investor would be committed not to tender shares during a hostile takeover.\textsuperscript{53}

\textsuperscript{49} Applying ‘Chinese Walls’ as a method of avoiding a conflict of interests, is discussed further in chapter six of this thesis.

\textsuperscript{50} See chapter one of this thesis.


\textsuperscript{53} ibid. at 1034.
As for short term investors, one could easily envisage that monitoring corporations and their managers would not benefit them. This is because most of the benefits brought about by monitoring corporations and their managers would be reaped in the long term. A short term shareholder might not perceive monitoring and intervening in corporate governance issues, such as electing new independent directors (non-executive directors), as beneficial to them, since the option of exit is largely available to shareholders in a corporation. In fact, it could be argued that short term investors may perceive monitoring and being active, as a creator of bad publicity, which could negatively affect share price and limit the option of exit.

The other argument that one can put forward is that it is in fact corporate governance in some cases that causes investors to take a long or short term view in holding investment in a company. This means that investors might be sometimes forced to take a short term view when they find themselves helpless to change the company for the better. Furthermore, it could be argued that some institutional investors might not intend to be short term investors but business needs related to raising money might push some institutional investors to sell shares in certain companies in a shorter time span than originally planned. Hence, it could be argued that in such cases it is not a short term view about the investment that causes apathy as such. Rather, a short term view is the result of the lack of ability to monitor and influence corporations and their managers or to satisfy the business needs of the company.  

For instance, one institutional investor argued that:

Only if they are not interested in the investment at all and looking for a "quick gain" – even so I would have thought that good practice implies looking at corporate managers' performance.

Nonetheless, this research sought to examine how institutional investors and investment managers perceive the influence of short term investment on the activity of monitoring corporations and their managers. The responses were very interesting. Table 2.20 (Appendix F) shows that investment managers were equally divided (50:50) on whether short termism is a reason for inactivity. The responses from

54 The annual conference of the N.A.P.F., 11 May, 2000. Institutional investors' questionnaire, control number 133, said that short termism causes inactive monitoring because holding periods are uncertain.

55 Institutional investors' questionnaire, control number 3.
institutional investors were slightly different as shown in Table 2.19 (Appendix F). 44.1% of institutional investors believed that short termism is a reason for inactive monitoring and 39.2% believed that it is not.

The evenly divided distribution of those respondents who agreed and disagreed that short termism affects investors' willingness to monitor corporations and their corporate managers, probably reflects the fact that there is no agreement on the meaning of short termism. The subject of short term investment deserves much more in depth analysis that is beyond the objective of this study.

2.3.10. Management Manipulation of the General Meeting Agenda

It has been argued that one of the main methods to control corporations and their managers is through voting. The law gives the right to shareholders to elect and eject corporate managers. Section 376 C.A. '1985 also gives shareholders the right to write a statement about the resolution, no more than 1,000 words. Yet, the company voting system in the U.K. gives corporate managers the advantage, which might allow them to manipulate the general meeting agenda. Corporate managers for example, would have the advantage of examining statement put forward by shareholders proposing a resolution, and prepare to defeat it. Their position further allows them to spin facts in relation to their own proposed resolutions, to defeat other resolutions suggested by shareholders. Moreover, other investors would usually trust management, rather than unknown shareholders initiating a protest. The voting system in U.K. companies is the subject of chapter five of this thesis. However, the aim of this subsection is to consider whether institutional investors and investment managers think corporate managers’ manipulation of the general meeting agenda is a reason for the inactive monitoring of corporations and their managers, or not.

56 See for example, Article 78 of Table A and s. 303 of the CA '1985.
57 In fact, the 1000 word limit on shareholders’ statement about a resolution that is provided s. 376 C.A. 1985 is longer than the word limit adopted by most of American States, where 500 words limit is provided. See, J. Coffee, 'Liquidity verses Control' supra, n 5.
The responses from both groups were very similar. Tables 2.21 and 2.22 (Appendix F) suggest that a small minority of less than 15% of both groups thought corporate managers' manipulation of the general meeting agenda is a reason for investors' apathy in monitoring corporations and their managers. A majority of 55.9% of institutional investors and a large majority of 78.6% of investment managers believed that corporate managers' manipulation is not a reason for inactivity in monitoring corporations and their managers. One institutional investor thought that such an, 'attempt to manipulate the agenda would be too transparent and obvious and therefore institutional investors would stop it.' It should be mentioned that the use of 'manipulation' might have not been a good choice of wording. It seems that the word is a sensitive one. This is because the word 'manipulate' may have predisposed respondents to a negative reply as it may have implied wrongdoing. A better word to have used which gives the same meaning -so far as this research is concerned- is 'control'.

Generally, the feeling from the comments on this question can be summed up as on institutional investor put it: '[s]hareholders can put resolutions if feeling particularly aggrieved. Also many discussions go on behind the seen – no vote.' This comment confirms some commentators' suggestions that dialogue between investors and corporate managers takes place behind the scenes. However, the latter comment suggests that voting and general meeting resolutions are not very relevant as a tool for monitoring and controlling corporations and their managers. This is surprising. In fact, a number of institutional investors and investment managers stated bluntly that the general meeting is irrelevant. One institutional investor said 'AGM is usually an irrelevant piece of legally required window dressing.' Another investor

58 Institutional investors' questionnaire, control number 146.
59 Institutional investors' questionnaire, control number 587.
60 See chapter six of this thesis.
61 Institutional investors' questionnaire, control numbers 104, 277, 587 and 634. Investment managers' questionnaire, control number 121.
62 Institutional investors' questionnaire, control number 634.
thought that 'investors should address issues outside AGM'. This issue is the subject of much deeper discussion in the second part of this thesis.

2.3.11. Political Retaliation

Legal scholars such as Roe have written about political retaliation as a reason that might negatively affect investors' monitoring and control of corporations and their managers. The case that is usually stated in this context is the Glass-Steagall Act in the U.S., which limited investors' powers by not allowing banks to exceed a certain threshold when holding shares in companies. In the U.K. however, political retaliation is not thought to be an issue. If anything, it is believed that the U.K. Government actually encourages the interference of institutional investors in corporate governance. For example, the U.K. Government supports shareholder participation in corporate governance issues such as executive pay and taking a longer term view in decision making.

63 Institutional investors' questionnaire, control number 277.


66 D.T.I. publications, including parts of the Company Law Review
The F.S.A.'s recent announcement that it would not tolerate 'selective briefing' is different from political retaliation. This is because it does not object to investors' involvement in corporate governance. It is rather based on treating all shareholders equally. In gauging the views of investment managers and institutional investors on this matter, both groups were asked whether they thought political retaliation is a reason for investment managers and shareholders' inactivity in monitoring corporations and their managers.

It was not surprising, as tables 2.23 and 2.24 (Appendix F) show, that approximately three quarters of both groups thought political retaliation was not a reason for investors' apathy in monitoring corporate managers. In fact, a negligible 2.9% of institutional investors thought political retaliation was a cause for inactivity. Although as Table 2.24 (Appendix F) shows, a higher percentage of investment managers (14.3%) thought that political retaliation could lead to inactive monitoring. There were no comments from those investment managers who thought that political retaliation is a reason for the inactivity of investors in monitoring corporations and their managers, to help clarify their opinion or provide a reason or illustration.

2.3.12. Investing in Index Funds and the Investors’ Ability to Influence Corporate Governance

Indexing is a very popular form of investment among institutional investors. 46.5% of the institutional investors who responded to the questionnaire invest in index funds. However, there is great concern about the effect of this method of investment when it comes to corporate governance issues. The problem with indexing in connection with corporate governance is that it does not give the legal owner of shares the power to be involved in monitoring corporations and their managers. For example, it does not give the legal owners the right to attend or vote in the general meeting. Hence, indexing no doubt affects the issue of monitoring of corporations and their managers.

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67 ‘Selective briefing’ is discussed in detail in chapter six of this thesis. In brief, it is a practice that generally favours significant investors, in particular, institutional investors and investment managers.
In exploring the effects of indexing on monitoring corporations and their managers, the study asked institutional investors and investment managers the direct question of whether they believed that investing in index funds rather than directly in shares, affects investors’ ability to influence corporate governance. The results were similar between both groups. As Tables 2.25 and 2.26 (Appendix F) demonstrate, the majority of over 58.8% of institutional investors and a majority of 57.1% of investment managers thought that investing in index funds, rather than directly in shares, negatively affects investors’ ability to influence corporate governance. On the other hand, 24.5% of institutional investors and 35.7% of investment managers thought that investing in index funds rather than directly in shares, does not affect investors’ ability to influence corporate governance.

Although a clear majority in both groups (as illustrated in Tables 2.25 and 2.26, Appendix F), thought investing in index funds is a reason that affects investors’ ability to intervene in corporate governance, this still came as a surprise. The initial expectation was that a higher percentage would agree that index fund investment is a reason that affects investors’ ability to participate in corporate governance. Nonetheless, strong views were expressed that indexing is an issue that needs to be regulated to give the legal owners powers to be involved in corporate governance.68

Some comments reveal the reason for the lower percentage than initially expected. Seven institutional investors and one investment manager stated bluntly that indexing is an incentive for engaging shareholders more in corporate governance issues. The argument here entails that indexing can be an incentive to monitor corporations and their managers as shareholders are locked in, indirectly to particular companies, especially those representing a high proportion of the whole market, since shareholders are unable to sell the shares. However, the problem is that the constitutional machinery of the companies in the U.K. does not give those who own an investment through an index fund the right to interfere directly with corporate governance issues. Rather, it is done indirectly and through the managers of the index.

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68 For example, institutional investors’ questionnaire, control number 343, said: ‘Index fund must be required to vote.’
2.3.13. Other Reasons that Affect Shareholders’ Willingness to Monitor Corporate Managers

Both institutional investors and investment managers were asked whether they believed there were any other reasons, (not already mentioned in the questionnaire) for the inactive monitoring of corporate managers by shareholders, and what these reasons were. Thirteen institutional investors and three investment managers provided reasons for apathy other than those mentioned in the questionnaire. The most popular reason provided was lack of resources; i.e. time and people. Four institutional investors and one investment manager thought that lack of resources was a reason for inactivity. Another reason provided was a failure to realise the importance of monitoring in enhancing performance. This might be the basis for investors’ belief that monitoring will not add any value to performance, as is the case when company performance is poor for reasons other than bad management. Institutional investors’ questionnaire, control number 431 stated: ‘[f]ailure to realize the possibility of adding value to investment corporate managers.’ Institutional investors’ questionnaire, control number 105, linked it to resources again, stating:

It may not be a priority i.e. corporate governance is one aspect of many when investing. All decisions / monitoring has to be balance of many aspects, some more important than governance issues.

Other reasons mentioned included: the limitation of internal control and procedures and compliance, habit of difficulty for foreign shareholders who are increasingly significant for UK companies; the option to exit the company; the reliance on the

69 The comments are as follows:

Institutional investors’ questionnaire, control number 418: ‘It’s very time consuming and the pay back is not enough.’

Institutional investors’ questionnaire, control number 343: ‘In my case, inadequate in the investment department (of one person!).’

Institutional investors’ questionnaire, control number 38: ‘Lack of time. Everyone is working flat out and inevitably some things have to be dealt with superficially rather than in depth.’

Institutional investors’ questionnaire, control number 100: ‘Organizations must have a very significant resource to effectively monitor all companies and this is costly.’

70 Institutional investors’ questionnaire, control number 440.

71 Institutional investors’ questionnaire, control number 773.

72 Institutional investors’ questionnaire, control number 587.
movement of share price rather than monitoring corporate managers\textsuperscript{74}; and finally, a very interesting comment mentioned by one of the investment manager respondents, the ‘[l]ack of knowledge /experience in institutions.’\textsuperscript{75} This exact reason was mentioned and emphasised by the Myners Review.

\textbf{2.4. Conclusions}

This chapter presented the results of the responses of U.K. institutional investors and investment managers that participated in this study’s questionnaires, in relation to the twelve reasons that allegedly affect investors’ willingness to monitor and control corporate managers, as well as an analysis of these reasons. By and large, the questionnaires of this thesis asserted the soundness of some of those reasons in the U.K. Moreover, the questionnaires revealed very interesting results, some of which are worth while in pursuing for further research.

It is worthy of note that the responses of both groups (investment managers and institutional investors) were often different with regards to the soundness of those reasons. However, the variation in the responses between the two groups may have been due to the difference in the nature of their roles. Despite the low tendency among respondents in considering political retaliation and comparison with other investors to be reasons for apathy in monitoring and controlling corporate managers, the results, particularly the investment managers group, were still much higher than expected, and should therefore, be subject to further research.

It also interesting that although the largest group of institutional investor respondents thought of investing in thin equity, diversification of investment, agents’ apathy, the short term vision of some investors, and indexing to be reasons for apathy, only the latter reason reached over the 50% threshold. The investment managers group on the other hand, did reach over the 50% threshold in perceiving liquidity of shares, reliance on others to conduct monitoring and indexing, to be

\textsuperscript{73} Institutional investors’ questionnaire, control number 733, stated: ‘Investor more worried about returns. If unhappy will change investment.’

\textsuperscript{74} Institutional investors’ questionnaire, control number 507: ‘Share price performance is the trigger for monitoring.’

\textsuperscript{75} Institutional investors’ questionnaire, deleted control number.
causes for investors’ apathy in monitoring and controlling corporate managers. Respondents were however, split equally (i.e. 50 : 50) in perceiving short termism as a reason that might cause apathy.

Collectively, the twelve provided reasons for apathy seem to form a serious hindrance on investors’ willingness to monitor and control corporate managers in the U.K. Yet, there is no doubt that some investors might not be affected by these reasons, or indeed, might be affected by these reasons but are still willing to monitor corporate managers, to achieve good corporate governance practices.

Hence, part one of this thesis concludes that there are some gaps in the U.K. corporate governance system that common law, the market, the Government and the legislature are constantly trying to respond to. In addition, and as shown in this chapter, the economical framework of corporate governance seem to have its own reasons that may result in shareholders’ apathy in monitoring and controlling corporations and their managers. Yet, in spite of these obstacles, some investors might still want to be active. In light of this, the second part of this thesis offers an evaluation to the availability of the existing legal means for institutional investors and investment managers in holding corporate managers to account. Part two commences with an evaluation of the underpinning theoretical framework of shareholders’ legal status in the U.K. and possible protections and remedies that could provide shareholders with the means to ensure good and sound corporate governance practices in companies. Specifically, part two of this thesis discusses the different theoretical approaches related to shareholders, shareholders’ contractual ability in large corporations and the ‘self-help’ approach, shareholders’ remedies, and the use of voting and proxies system.
Part Two
Chapter Three

Theoretical Approaches to Shareholders in Listed Companies

3.1. Introduction

A review of the literature on the theory of the company provides clear evidence on
the different approaches to shareholders' legal status. Legal theorists have produced
numerous legal theories regarding this matter. However, concentration will lie on a
discussion of how shareholders are perceived from the viewpoint of three of the
main theories on the corporation, since these theories are the most appropriate in
relation to the framework of the empirical work of this thesis. Namely, these theories
are: corporation communitaire, corporation concession, and corporation contractual
or corporation aggregate.¹ Significantly, the political stance of legislators in relation
to these theories may well have affected the way legislation was and still is
constituted today.²

Corporation communitaire theory³ perceives the corporation as a commodity to
maximise a society's interests. Corporation concession theory on the other hand,
perceives the existence and operation of corporations as a concession by the state

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¹ F. Sami, Commentary on the Commercial Code: Part 4, (Dar Althakaffar, Amman,
1996); J. Coates, ‘Note, State Takeover Statutes and Corporate Theory: The Revival
of Chicago Law Review, 1441; J. Dewey, ‘The Historic Background of Corporate

² For example, a legislator with the political stance of a capitalist would be inclined to
apply contractual theory. On the other hand, a legislator from a socialist, political
background might be inclined to apply corporate communitaire theory.

Professor Boatright’, (1996) 34, American Business Law Journal, 239; R. Romano,
‘Theory of the Firm and Corporate Sentencing: Comment on Baysinger and Macey’,
Seligman, Taming the Giant Corporation (W. W. Northern & Company Inc, New
York, 1976).
that is initiated by the corporations’ members. Such a concession allows corporate members to use the company as a ‘vehicle’ to trade with limited liability. The main difference between corporation communitaire theory and corporation concession theory is that the former proclaims that corporations are created by the state and should only be allowed to operate in order to serve society, while the latter accepts that the role of the state is to regulate corporations, ensuring that they trade fairly through a sound corporate governance structure.

The third theory is corporation contractual theory, which focuses on the interests of shareholders. Economists have provided their own version and analysis to corporation contractual theory, also called new classical theory of the corporation. The new classical theory of corporation is mainly geared to explain management behaviour, and to challenge the traditional corporation contractual theory, which relies predominantly on the theme of corporate legal personality. Instead, the promoters of the new classical theory of the corporation purport that corporations represent a mere nexus of contracts between various corporate actors that are interested in the affairs of the company (i.e. shareholders, directors, employees, etc).

It is evident that the contractual and communitaire theories represent two opposite sides of the spectrum on issues related to the position of shareholders in public listed companies, leaving the concession theory to provide a less extreme ‘middle way’. Although each one of these theories has its’ own convenient structure that affects shareholders’ status in many different ways and forms, these theories still in no doubt overlap and interweave, as will be discussed below. By and large, corporation communitaire theory promotes the state’s creation of corporations and hence, the interests of shareholders are insignificant unless they go in harmony with

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maximising the welfare of society. Corporation concession theory is related to state intervention in helping to assure fairness, such as providing legal protection to shareholders. Contractual theory, however, is discussed as a form of ‘self-help’ that shareholders may make available to themselves through the means of contract negotiations.

Relaying on shareholders’ power of contract negotiating could be a very useful tool in providing more protective terms in company constitutions for shareholders’ interests. Yet, that is conditional on shareholders’ ability and willingness to use such a tool. The danger of relying solely on contract negotiation as a tool to provide protective terms for shareholders is that it could undermine the importance of the role of regulations. In fact, relying on contract negotiation as a tool to provide protective terms for shareholders might lead shareholders to lose both pathways of protection (i.e., state regulation and contract negotiation). Moreover, shareholders (particularly significant ones), might be able to provide themselves with excessive protection terms for themselves, rather than the whole body of shareholders. This is why it is necessary to gain an empirical insight to how contractualism is viewed by institutional shareholders and investment managers, as the most viable groups to be able to negotiate for more protective contract terms.  

3.2. Objectives

This chapter has three main objectives. The first objective is to discuss corporation theories and their relationship to current corporate governance practices in the U.K. The second objective is to examine the influence of these different theoretical approaches on the U.K.’s proposed changes to shareholders’ status in the Company Law White Paper 2002. The third objective is to provide empirical evidence of shareholders’ awareness to self-help options that originate from contractual theory.

The purpose of this chapter is neither to disprove nor affirm any of these theoretical approaches to shareholders. It simply aims to provide a background to the


7 Modernising Company Law: Presented to Parliament by the Secretary of State for Trade and Industry by Command of HM July 2002, Cm 5553-I & II.
protections discussed in the second part of the thesis body, by underpinning how shareholders' interests within the corporation are perceived by these different theories. This chapter also aims to provide an insight to contractual theory by providing empirical evidence of its application in the U.K. as a means of preventing corporate management from abusing their power within a company.

This chapter argues that historically, the U.K legislatures were equally influenced by those theories. These three theories have been collectively influential in shaping models of companies. Thus, the significance of discussing these theories in this study is that they usually provide an explanation to the different approaches in company law regarding shareholders' protections from corporate management and the legal status of other groups within a corporation. Bottomley for example asserts that:

The board and basic purpose of examining corporate theory is to develop a framework within which we can assess the values and assumptions that either unite or divide the plethora of cases, reform proposals, legislative amendments, and practices that construct modern corporation law. This law has not sprung up overnight. We need some way of distinguishing the different philosophical and political perspectives from which it has been constructed.

In following on from Bottomley's statement, the following sections will examine the above mentioned theories in detail in order to gain a deeper insight into how they have influenced the role and position of shareholders in U.K. public listed companies today.

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9 See K. Greenfield, 'From Rights to Regulation', in F. Patfield (ed.), *Perspectives on Company Law: 2*, (Kluwer, London, 1997). Greenfield argues that: 'one cannot intelligently discuss whether a corporation is acting responsibly when it shuts down a factory without taking a position on the role of corporations in society'.

3.3. Corporation Communitaire Theory

This theory was modelled in the former communist countries and fascist Italy. Corporation communitaire theory states that corporations do not only need the state's approval to exist and operate, but are also created by the state as a utility or commodity to serve its interests. This necessarily entails that the state has the right to alter or destroy a corporation at its disposal. According to corporation communitaire theorists, reining corporations in is a necessity in order to prevent corporations from accumulating great power that allow them to undermine the state.

Being a mere creation of the state necessarily weakens the commercial identity of corporations. According to this theory, the commercial identity of a corporation must be weakened to give corporations a clear set of goals to achieve. Accordingly, corporations would be set goals to serve the state and society, rather than diffusing the corporations’ goals in trying to achieve both commercial and social responsibilities. A corporation communitaire theorist would picture the corporation to be no more than a political tool for serving and pursuing state polices. Therefore, corporation communitaire theory departs from the idea that the corporation is a wealth creation entity to its members which helps towards providing better welfare for the whole of society.

There is a difference of opinion among corporation communitarian theorists concerning where the notion of public social responsibility should stop. In fact, corporation communitarian theorists have provided neither a consensus on what corporate social responsibility actually means, nor a precise criterion to determine the public responsibilities of companies. Some communitarian theorists are more extreme that others with regards to shareholders’ legal status in the corporation.

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11 J. Dine, supra, n 8, at 17.

12 This theory in no doubt has it strongholds in the Western World. Section 110 (McKinney, 1985) of the New York Business Corporation states, for example: ‘[t]he legislature reserves the right, at pleasure, to alter, amend suspend or repeal in whole or in part […] any certificate of incorporation.’


14 See, M. Phillips, supra, n 3, at 241.
mildest form of corporation communitaire theory is very similar to corporation concession theory.\textsuperscript{15} Wedderburn, for example, promotes corporation communitaire theory as a theory that supports corporate social responsibility through aiming to maximise profits for corporations.\textsuperscript{16}

However, it should be noted that aiming to maximise profits for corporations is not the same as maximising returns and gains to shareholders. Hence, even the mildest view of a corporation communitaire theorist abandons focusing on the interests of shareholders as the core interest of corporations. This entails that the interests of shareholders are only acknowledged if they concur with maximising the profits of a corporation. Wedderburn believes that the social responsibility of corporations and shareholders’ profit maximisation, go hand in hand, stating that:

> The “social” expenditure so explained becomes no more than “seed corn”, sown in the surrounding ground with a long-term view of profit, scattered because: “The best place to do business is in a happy, healthy community.”

Similarly Greenfield states:

> It is tempting to explain away the apparent tension between shareholders and other stakeholders by focusing on the long run. In the long run [...] corporations maximise the return to shareholders by being good citizens. Concern for employees, for example, engenders loyalty, which will include employees to accept lower wages and care more about product quality and company profitability.\textsuperscript{17}

Dodd on the other hand, although being a communitarian theorist, took a stricter view than other communitarian theorists, such as Greenfield and Wedderburn. Dodd prompted by Berle’s thesis, which purported that corporate managers should act as trustees to shareholders in order to maximise their profits,\textsuperscript{18} argued that a corporation should focus solely on maximising the welfare of society.\textsuperscript{19} The main

\textsuperscript{15} Concession theory is explained later in this chapter.
\textsuperscript{17} K. Greenfield, supra, n 9, at 3-4.
\textsuperscript{19} Dodd stated: ‘[t]he present writer [Dodd referring to himself] is thoroughly in sympathy with Mr. Berle’s effort to establish a legal control which will more effectually prevent corporate managers from diverting profit into their own pockets
contribution made to corporation communitaire theory by Dodd demonstrated how the idea of the artificial or juristic entity of a corporation (i.e., being an entity that is separated from its shareholders), could provide a theoretical basis for corporations to serve the state, aiming to enhance the welfare of society collectively. In Dodd’s view, the fact that corporations are different from shareholders provides a suitable justification for the corporation to have sets of objectives that may be disassociated from the interests of shareholders. In other words, Dodd justified corporate policies that might reduce shareholders’ profits by assuming that management owes a fiduciary duty to the corporate entity rather than to its shareholders.

Dodd’s view ignited a long and interesting intellectual debate with Berle on how shareholders should be perceived within the corporation. Dodd argued that a corporation through its management should behave as a good citizen. For the corporation to achieve the goal of being a good citizen, it should comply with its duties and responsibilities to all of its employees, creditors, consumers, and the

from those of stockholders, and agrees with many of the specific rules which the latter deduces from his trusteeship principle. He nevertheless believes that it is undesirable, even with the laudable purpose of giving stockholders much-needed protection against self-seeking managers, to give increased emphasis at the present time to the view that business corporations exist for the sole purpose of making profits for their stockholders. He believes that public opinion, which ultimately makes law, has made and is today making substantial strides in the direction of a view of the business corporation as an economic institution which has a social service as well as a profit-making function, that this view has already had some effect upon legal theory, and that it is likely to have a greatly increased effect upon the latter in the near future.’ E. Dodd’s famous thesis, ‘For Whom Are Corporate Managers Trustees?’, (1932) 45 (7), Harvard Law Review, 1145, at 1147-1148

ibid.

E. Dodd, supra, n 19, 1145.

For example, see E. Dodd, supra, n 19, and A. Berle, supra, n 18. For example, Berle in supra, n 18, stated the following:

‘[A]ll powers granted to a corporation or to the management of a corporation, or to any group within the corporation, whether derived from statutes or charter or both, are necessarily and at all times excisable only for the rateable benefit of all the shareholders as their interest appear.’

The debate between Berle and Dodd was never stilled, despite the fact that they came very close at times. For a good summary of the debate between Berle and Dodd see, J. Weiner, ‘The Berle-Dodd Dialogue on the Concept of the Corporation’, (1964) 44, Colombia Law Review, 1458; in particular, at 1461 –1467, which manifests how the two very distinct professors came very close to settling their long existing debate, but never quite managed to do so.
general public, as well as its shareholders. Therefore, according to Dodd’s version of corporation communitaire, shareholders lack the power to oppose a company’s public responsibilities. This is because management spends the company’s money rather than that of shareholders, in carrying out such responsibilities. Accordingly, not only do minority shareholders lack the ability to oppose management decisions, but also, the whole collective body of shareholders.

This theory generally, offers little help to shareholders’ legal status as far as protecting them from the abuse of management is concern. The only duty that corporate managers should abide by, as far as shareholders are concerned, is to look after shareholders’ interests, if such interests go in harmony with achieving the state’s goals. In fact it might be true to say that this theory holds corporate managers accountable to the state; similar to a civil servant, in that, corporate managers should achieve better welfare for the society in general.

Dodd justified his public approach to corporations by adhering to the notion that the corporation is a legal entity which acts as a means to differentiate corporations from their shareholders. Consequently, this encouraged numerous other corporation communitaire theorists to focus on this theme. The idea of the corporation as an artificial entity, was invented in the very early stages of corporate law history and certainly prior to Dodd’s usage of this theory. In fact, it could be argued that the notion of the corporation as an artificial entity was the earliest concept to characterise companies in the U.K.

As asserted by Dodd, the notion of the corporation as an artificial entity entails the view that the corporation as an entity is separate from its shareholders and other parties who own and control it. In addition, the company is considered as an artificial entity due to the fact that it owes its existence to the positive law of the

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24 See, M. Phillips, supra, n 3; R. Romano, supra, n 3; and R. Nader, M. Green and J. Seligman, supra, n 3.

25 The idea of an artificial entity within a company can be traced back to England immediately subsequent to the Middle Ages, to what used to be called the Royal Charters, which dominated the legal discourse in both England and the majority of the American States in much of the 19th century. See, C. Carr (ed.), Select Charters of Trading Companies xv-xvi, (London, B. Quaritch, 1913).
state, rather than the private initiative of individual incorporation. Hence, the main aim of the artificial entity theory has been to justify the public law approach (as part of communitaire theory) to company law, by arguing for the implementation of various regulations whilst at the same time, addressing important public concerns. For artificial entity theorists, the emphasis on the public approach to company law is not without its reasons. In fact, there are two main reasons for using the public approach by artificial entity theorists; namely: the fear that companies would monopolise the market; and, that controllers of those companies would be able to generate political power, which could potentially undermine the state and be exercised in ways that were contrary to public interest.

Following on from the artificial entity theory, several steps have been taken by legislatures to avoid the above two fears. For example, to prevent any single company from achieving a monopoly, corporate statutes balance companies‘ power by ensuring competition among a number of companies and preventing a small quantity of corporations from dominating the economic landscape of a certain trade. Legislatures were also reluctant to rely only on the market to regulate and organise corporate power. Hence, charters contain limitations on corporations‘ activity by restricting their purposes and power. This has been achieved by limiting corporations‘ capital, limiting their durational existence, and imposing the doctrine of ultra vires. The doctrine of ultra vires in particular, serves to keep the state


27 These fears occurred because of the expansion of the companies‘ affairs in the last third of the 19th century. One could argue that before this, businesses were predominantly run by either one person or close-knit families. (See, G. Mark, supra, n 1, at 1444).

28 At a later stage of company law history, certain American States began to replace special chartering with general incorporation laws. These incorporation laws simply made the incorporation charters available to those applicants who complied with the general requirements of law. The requirements of the state-granted charter emphasised the idea that incorporation was an artificial creation of the state. The reason for keeping corporations dependent on state action was to ensure that they followed the objectives of the state‘s public policy, which is where this theory lends itself to corporation communitaire theory.

Historically, the ultra vires doctrine meant that a corporation could not bind itself to a contract dealing with a matter beyond the corporation‘s objectives, as defined in its charter. Even unanimous shareholders could not create powers not conferred by the
informed of corporations' business, reserving the right to reign in a corporation's power in adhering to state policy.  

More recently, Teubner reinforced the notion of the artificial entity of the corporation as a method of legitimising corporate social responsibility. Teubner proposes that since corporations are different in identity to their shareholders, they are entitled to have a different set of aims and objectives. Teubner states:

Collectivisation means a shift in the attribution of action from one social construct to another, from a 'natural' to a 'legal' person. A self-description of the system as whole is produced and to this construct actions are attributed as actions of the system. This is a self-supporting construction: collective actions are product of the corporate actor, and the corporate actor is nothing but the product of these actions.

state. In the U.K., the problems caused by the doctrine of ultra vires have been long acknowledged. The Cohen Committee in 1945 (Cmnd 6659) recommended the abolition of the doctrine of ultra vires. The Jenkins Committee also later suggested part abolition of the doctrine of ultra vires in 1962 (Cmnd 1749). It was not however, until 1973 that reforms to the doctrine of ultra vires took place with the U.K.'s entry to EEC. The reforms then took place to comply with Art 9 of the 1st EEC Company Law Directive. Section 9(1) of the European Communities Act, was passed to protect any person, dealing with a company in good faith, from the effects of a transaction outside the capacity of the company. This has now been replaced by s. 35 C.A. '1985.

The Final Report of the Company Steering Group (Modern Company Law for Competitive Economy: the Strategic Framework, DTI 2001) has recommended further reforms. It suggested, inter alia, that the purpose of a company would not have to be included at all in its constitution, and that companies formed under the new legislation would no longer have limited capacity. The Government embraced most of the suggested reforms in the White Paper, 'Modernising Company Law', (Cm 5553-I, paragraphs 2.2, 2.3 and 6.2.), see B. Hannigan, Company Law, (Butterworths, London, 2003), chapter 4.

It should be noted that there is no consensus among corporate communitarian theorists on the stance of the ultra vires doctrine. Dodd, for example argued against the doctrine of ultra vires, leaving the power of corporations in the hands of management to dismiss the ultra vires doctrine, which might result in leaving the shareholder unprotected in order to satisfy public responsibilities. In other words, company shareholders who contribute their money to the company, leave it to the mercy of management to decide what is in the best interests of the company. On the other hand and as mentioned above, other corporate communitarian theorists argued for the doctrine of ultra vires, perceiving it as a 'safety valve' in the hands of the state to keep monitoring and controlling corporations.


ibid. at 139.
Teubner argues that corporations have a degree of autonomy. This in part would entitle them to have different sets of interests and objectives to those of their shareholders. Such an argument however, is self-defeating. This is because the autonomy of corporations and their independence from shareholders should not, logically, lead to dependence on the state and in serving to deliver better welfare to society. It would rather mean that corporations are independent and separate from both their members and the state. Accordingly, relying on the argument that corporations are autonomous does not oblige corporations to serve society.\textsuperscript{32}

Other corporation communitaire theorists' such as Stokes\textsuperscript{33} have approved corporate social responsibility as advocated by Dodd and others. Yet, Stokes for example, has also placed emphasis on the interests of other groups within the corporation, (i.e., employees, management, shareholders, creditors, etc) as well as society in general. In the U.K., Sheikh has argued for the legislatures to introduce new legal instruments to allow directors to pursue social welfare policies for the benefit of the wider community. Sheikh’s thesis however, does not particularly emphasise any logical theoretical basis for such an approach.\textsuperscript{34} Recent corporation communitarian theorists, although not retreating from the main idea that corporations do depend on the positive acts of the state to exist and operate, have moved away from solely focusing on corporations as a means of furthering the welfare of society, to include the interests of various groups. In doing so, some corporation communitaire theorists have adopted a similar approach to that taken by corporation concession theory, as is will be demonstrated later in this chapter.

Despite the fact that the core of the approach taken by corporation communitaire theorists has been to justify the public approach to corporations, some theorists

\textsuperscript{32} J. Dine, supra, n 8, at 19.


including Dodd, have incorporated the 'managerial approach'\textsuperscript{35} into the theory, which argues that managers are trustees to the company and not shareholders. In doing so, theorists have attempted to justify the excessive powers of corporate managers in corporations, alongside the inadequate powers given to shareholders. However, the managerial approach could lend itself better to corporate concession theory. This is because the managerial approach advocates that corporate managers should have excessive powers to serve the company as a commercial entity, rather than serving the state.

In conclusion, although historically, corporate communitaire theory influenced and affected the running and practices of British corporations immediately subsequent to the Middle Ages, today, it has no significant effect on British corporations. Indeed, corporations are expected to behave like good citizens, serving the society that they practice their business in. However, a corporation's mere existence is not to serve the state in furthering the welfare of society. The main lack of appeal of corporation communitarian theory in a capitalist country is that it ignores shareholders' interests, yet expects business prosperity that leads to furthering the welfare of society. Moreover, the fact that the core of the theory is founded upon defining the corporation as a separate legal entity, which should be independent from its shareholders, is somehow flawed. Indeed, such a maxim of corporation legal entity, justifies that corporations could have interests that are different to the interests of shareholders. Nonetheless, the theory fails to convincingly explain how such an artificial separate legal entity (i.e. the company) could still be dependant on the state, serving to achieve the states objectives.

\textsuperscript{35} i.e., justifying corporate managers’ excessive powers in large corporations, arguing that it is simply a natural division of skills. The managerial approach to corporations is discussed in more depth later.
3.4. Corporation Concession Theory

This theory asserts that although the state is not the creator of corporations, corporations still need to be conceded by the state in order to exist and operate. Concession theory rather argues that corporations are the creation of the private initiative of their promoters. The way in which corporations are created is the underpinning principal difference between corporation communitaire theory and corporation concession theory. While on one hand, corporation communitaire theory purports that corporations owe their existence and operation to the state where they register and function, concession theory on the other hand perceives the role of the state to be merely procedural and facilitative, which gives shareholders a better status in corporations than their status under corporation communitaire theory.

Hence, according to corporation concession theory, shareholders enjoy a reasonable position, being allowed to initiate their businesses, with minimum interference from the state. In playing a facilitative and monitoring role, the state would allow corporations' promoters and shareholders to agree on what is suitable for their business, so long as it agrees with the state's public policy.

When the needed documentation and information concerning the establishment of a new company, is presented to state officials, they have no option but to register the corporation. In this case, they have no discretional powers (except with minor exceptions) to approve or reject such a proposal, i.e. refuse to certify the articles of incorporations. It is also the case that state officials would not be able to demand

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36 Arguably, this theory is based on English company law history, which can be traced back to the 'South Sea Bubble' Act from the Middle Ages, when it was up to the Crown to 'grant' privileges to establish a company. The idea of charters in England in the Middle Ages did not clearly manifest concession theory. Concessions at that time were blurred between concession and communitaire theories. See, Gower, 'Some Contrasts between British and American Corporation Law', (1956) 69, Harvard Law Review, 1369.


38 This view eliminated some significant limitations. For example, New Jersey 1888 corporation law facilitated the creation of enormous holding companies. See Liggett Co v Lee, 288 US 517,550-54 X nn.2-26 (1933).

39 It is true that in the U.K., the Company House has very little discretion over registering a company if the documentations are complete. Their decision is also subject to judicial review.
any extra documentation. When such documentation is complete, state officials would issue the ‘certificate of incorporation’ and keep information about the company in the company file.

According to concession theory, the state’s role is not to create the company. It is rather to ensure that the corporate governance structure is fair and sound. In relation, corporation concession theorists make a simile between the state’s role of registering corporations and its role of recording the birth of every baby and the registration of every sale of land. Corporation concession theorists claim that in the above three scenarios, the state’s role is minimal, beyond recording the event. Yet, there is more to the state’s role, regarding corporations. This is due to the fact that the state would wish to continue monitoring that corporations are always committed to the state’s public policy after being registered. This approach is clearly different from corporation communitaire theory, which believes corporations should only serve the welfare of society.

One can argue that what has followed on from concession theorists’ claim that the state’s role is limited in making sure that the corporate governance structure is fair and sound, has been intervention by the legislature’s and courts, by introducing the unfair prejudice remedies (see chapter four of this thesis, though it has a very limited, if any effect at all, on shareholders’ legal status in public listed companies). Such intervention could indeed be interpreted as ensuring that the corporate governance structure is fair and sound.

Like corporation communitaire theory, concession theory insists on the notion that the corporation is a separate legal entity. However, unlike corporation communitaire theory, concession theory perceives the corporation as having an existence outside the law. Laski for example, states: ‘[t]he corporation, being a real entity, with a personality that is self-created and not state-created, must bear the responsibility for

its actions.\textsuperscript{41} Therefore, corporation concession theorists have found more plausible means to justify the notion of the corporation as a separate entity to the state; that like the natural person, a corporation should be independent from both the state and its members. Hence, since the state only recognises the entity of corporations, it is free to regulate corporations in the same manner and within the same legal limit of organising its real life citizens. This is different to the stance of corporation communitaire theorists, who in relying upon corporation artificial entity theory, argue that the state for example, should have the ability to extinguish companies, rather than simply regulating them.\textsuperscript{42}

To most concession theorists, it is the will of corporations' members that initiates the creation of corporations. However, once a corporation is initiated, it is an independent legal entity from those who originally initiated it. Moreover, concession theorists assert that due to the state's recognition of this new born entity, it is justified in interfering with the 'life' of this new born company, in the same way the state interferes with the life of its private citizens. Dewey for example, argues:

\begin{quote}
[w]hen a body of twenty or two thousand or two hundred thousand men bind themselves together to act in particular way for some common purpose, they create a body which by no fiction of law but the very nature of things, differs from the individuals to whom it is composed.\textsuperscript{43}
\end{quote}

There are many versions of concession theory. Some adaptations are similar to corporation communitaire theory, whilst others are similar to corporation contractual theory.\textsuperscript{44} This is so much so in the case of corporation communitaire theory that some authors have even confused the two theories together. Hessen for example states: '[t]he corporation is a creature of the State. It is presumed to be incorporated for the benefit of the public.'\textsuperscript{45} However, Hessen goes on to state:

\begin{quote}
[k]nown as the "concession theory," this view holds that incorporation requires governmental permission or authorization, and that through its charter a
\end{quote}

\begin{thebibliography}{9}
\bibitem{42} ibid. at 426.
\bibitem{44} See, R. Hessen, supra, n 40, at 1327.
\bibitem{45} Hessen quoted from \textit{Hale v Henkel}, 201 U.S. 43, 74 (1906).
\end{thebibliography}
corporation receives various special privileges that only a government can create and confer, such as limited liability. These "special privileges" allegedly give a corporation an advantage in competition with noncorporate business, such as partnerships, hence; corporations are more likely to survive, grow, and reap profits. In exchange, however, the corporation is expected to display a sense of "social responsibility," that is, to place public service ahead of private profit.\(^4^6\)

Hessen's view, although he considers himself to be a concession theorist, clearly fails to acknowledge private initiatives at all. Thus, Hessen’s view could easily be associated with corporation communitaire theory more than corporation concession theory.

It should be noted that some theorists have used corporation communitaire and corporation concession theories rather loosely in justifying corporate social responsibility. In fact, the majority of concession theorists accept that corporate managers must take into consideration the interests of other stakeholder groups, other than those of shareholders, as long as they do not oppose shareholders’ financial interests. In truth, some concession theorists are very forceful in pushing for the application of corporate social responsibility. This is to such an extent that they can be considered very close in their approach to corporation communitaire theorists. White for example states:

\[\text{[t]o say that a corporation's only goal is to make money would be to define the business corporation -for the first time in American or English law as I understand it- as a kind of shark that lives off the community rather than as an important agency in the construction, maintenance, and transformation of our shared lives.}\(^4^7\)

White's argument does not depart from the idea of the corporation as a profit making entity; rather it stresses the social responsibilities of corporations. White further, uses the simile (familiar to this approach) between corporations and natural citizens,\(^4^8\) arguing that the corporations’ capacity to make money is dependent upon the maintenance of a stable economic and social order. Hence, corporations must have a commitment towards the community in which they exist. In turn, in

\[^{46}\text{See, R. Hessen, supra, n 40, at 1327.}\]


\[^{48}\text{See for example, p 94 of this chapter.}\]
considering the community’s interests, corporations would help to ensure their continuation.\(^{49}\)

Thus, corporation concession theory could easily be distinguished by three characteristics, asserting that: first, corporations are created by the initiatives of private/individual investors (corporation promoters and later on, shareholders), in which they need the approval of the state to exist and operate; second, corporations can be considered as independent natural persons, separate from their shareholders, but represented by the management team; and, third, corporations should act like responsible citizens; enjoying the social right to act freely; yet, adhering to the state’s laws and regulations. Consequently, management has to take into consideration the company’s public responsibilities. Corporation concession theorists promote freeing corporations from state-imposed restrictions on their ability to accumulate wealth, arguing that a corporation as a ‘person’ owes no greater obligations and responsibilities than a natural person. It is the first characteristic that really distinguishes this theory from corporation communitaire and corporation contractual theories. The second and third characteristics however, do overlap with corporation communitaire theory.

Some concession theorists have justified the element of the state’s intervention in corporations on the basis that the state gives concession to these corporations. Such a concession characterises corporations as separate legal entities that are ‘perpetual’ and able to sue and be sued in their own name, leaving shareholders to enjoy the notion of limited liability. Dahl for example affirms:

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\text{[...]} \text{it is absurd to regard the corporation simply as an enterprise established for the sole purpose of allowing profit-making. One has simply to ask: Why should citizens, through their\(^{50}\) government, grant special rights, powers, privileges, and protections to any firm except on the understanding that its activities are to fulfill their\(^{51}\) purposes? Corporations exist because we allow them to do so.}^{52}
\]

\(^{49}\) J. White, supra, n 47, at 1418-1419.

\(^{50}\) Italics in the original text.

\(^{51}\) Italics in the original text.

Concession theorists have also disagreed on shareholders' primacy legal status within the corporation. For some concession theorists, such as Berle and Means, corporate managers' fiduciary duties are primarily owed to the company's shareholders, rather than the general public. Yet, in their book *The Modern Corporation and Private Property*, it is clear that Berle and Means, definitely supported the notion of corporate social responsibility. Whereas Berle and Means did not coin the phrase 'social responsibility', they indeed supported and lent justification to the idea that the primary obligation of large corporations is to serve society, rather than to make profits for its shareholders and officers. Berle and Means stated:

> [...] the owners of passive property [i.e., shares], by surrendering control and responsibility over the active property [i.e., assets], have surrendered the right that the corporation should be operated in their sole interest; they have released the community from the obligation to protect them to the full extent implied in the doctrine of strict property rights. At the same time, the controlling groups, by means of the extension of corporate powers, have in their own interest broken the bars of tradition which require that corporation be operated solely for the benefit of the owners of passive property.

Others concession theorists came to a similar stance on shareholders' legal status in the corporation to that purported by corporation communitaire theorists, arguing that corporate managers should extend their responsibility to all interests groups in a company. For example, White eloquently advocates for including the interests of other groups in the corporation as:

> [...] the mistaken view that the corporation "is" its shareholders, to whom alone fiduciary obligations extend, and who are related only by contract to the others who make up the corporation's world—employees, suppliers, customers, and the like. From a sociological point of view, this is simply wrong: The corporation is the centre of a web of mutually-benefited relations extending in many directions, and management has always known this. Good citizenship

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54 In fact, it would be inaccurate to claim that Berle and Means were strictly in support of corporation concession theory. They rather, incorporated various theories on the corporation into their argument, particularly corporation concession theory and corporation contractual theory. See, Berle and Means' argument for corporation contractual theory below in the next section.

55 Berle and Means, for example, argued that the key feature of large and powerful companies was the transfer of control from the hands of owners to the hands of small groups of professional managers.

56 A. Berle and G. Means, supra, n 53.
requires recognition of this plain social fact. The section’s picture of shareholders is wrong too. Instead of hypothesized individual investors making long-term investment judgements based on the long term merits of a business concern, the dominant shareholders at the level of national markets are enormous institutions who act in the interests of others who have, as citizens, every interest in the social health of the community as a whole. And even in strictly economic terms, the conduct of these institutions makes the image of canny investors inappropriate, for such institutions often seek to diversify their investments to approximate a market index. To the extent that such institutions trade heavily in an attempt to increase short-term return, it is true that they deviate from the model of investing in the whole society, but the deviation is certainly not in the direction of long-term judgments about the soundness of enterprises in which they invest.\footnote{J. White, supra, n 47, at 1422-1423.}

Such a view can be compared to corporation communitaire theory, in the sense that it does not give shareholders any primacy status when dealing with groups’ interests. Furthermore, it ignores the notion of shareholders as risk bearers to justify shareholders’ primacy status in corporations, stating that shareholders look after their interests by diversifying investment and being short-term investors.

Other concession theorists argue that corporate managers are trustees for shareholders. In other words, management is viewed as a trustee/agent for shareholders. Theoretically, depicting management as shareholders’ trustee provides a balance for management’s power. Like any other trustee, the power of management is subject to substantive equitable limitations. The use of the trust and property analogy has led to the inevitable conclusion that trustees must act as if they own the property. This was, therefore, to provide protection for shareholders who had invested in the company.

Unlike White and others, the promoters of this theory have supported the view that corporate management should only be accountable to shareholders, rather than involving other stakeholders groups, such as employees or creditors. According to such theorists, this would be a more effective method of monitoring and, if needed, a means of holding corporate management to account. The rationale behind this belief
is that being accountable to many might consequently lead to being accountable to none.⁵⁸

The notion of ‘shareholders primacy’ as stated in Berle and Means’s thesis was not entirely new then. The origin of this notion can be traced (if not before) back to the judgement in *Dodge v Ford Motor Co*⁵⁹ The facts of this case entailed that in 1903 Henry Ford, the Dodge brothers and five other individuals, established a company for the purpose of producing cars; Ford being placed in the role of manager.⁶⁰ The company accumulated an enormous surplus through a highly profitable operation.⁶¹ However, in 1916, Ford decided not to distribute the surplus profit, but instead planned to use the surplus in expanding the company’s production, as well as spreading the wealth to employees in the company, rather than its shareholders.⁶²

The Dodge brothers challenged Ford’s decision on the basis that by attempting to promote public interest, he was violating their rights to benefit from their own property. They also argued that such a decision would result in a precedent that would directly jeopardise the rights of the company’s investors. Consequently they

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⁵⁸ See, stakeholders’ debate in chapter one. See also, the King Report. The King Report is published by the King Committee, which was established in 1992, by the Institute of Directors in South Africa. The King Committee produced its first Report in 1994, which was followed by a second Report in 2002. The Report eloquently argued that corporations should take into consideration, the interests of a wide range of stakeholders and that there should be a participative and sound corporate governance system, which should be applied with integrity. Yet, the King Report clearly distinguished between responsibilities to stakeholders and the fact that companies should be accountable only to shareholders, convincingly arguing that for corporate managers to be accountable to more than one group is like being accountable to none. See chapter one of this thesis and: <http://www.worldbank.org/html/fpd/privatesector/cg/docs/king.pdf> (May 2004)


⁶⁰ Henry Ford held 58% of the company; the Dodge Brothers held 10% and the rest of the shares were split between five shareholders.

⁶¹ From the year 1908, the company decided to disperse $1.2 million between shareholders as an annual profit. Moreover, in the period between December 1911 and October 1915, the company distributed $41 million between shareholders as a surplus profit.

⁶² According to the Detroit City Press, Mr. Ford declared: ‘My ambition is to employ still more men; To spread the benefits of this industrial system to a great number, to help them build up their lives and their homes. To do this, we are putting the greatest share of our profits back in the business.’ As in 170 N. W. at 671 (1919).
argued, this would affect public interest because of the lack of investors' motivation to invest in the stock market, which in turn would affect the whole economy.\footnote{The Dodge Brothers could not rely on the ultra vires principle as the basis of their challenge against Ford's decision. This was because Ford's decision was consistent with the company's objectives as stated in the charter, which included the 'purchase manufacture and placing on the market for sale of automobiles' (170 N.W. 669).}

The Michigan Supreme Court denounced the conduct of the management in the Ford case for primarily benefiting employees in the company, rather than shareholders. It stated:

> A business corporation is organised and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of the directors is to be exercised in the choice of the means to attain that end, and does not extend to a change in the end itself, to reduction of profits, or to non distribution of profits among stockholders in order to devote them to other purposes.\footnote{170 N. W. at 648.}

The court's statement clearly supported the notion of holding management accountable as shareholders' trustees. This opinion indeed supports the notion that shareholders should become the fundamental postulate of corporate law, and is the standard response to arguments in favour of a company's social responsibility. Accordingly, corporations seeking to act in a manner apparently contrary to shareholders' interests must be identified either by a statute or the corporate charter. An example of statutory authorisation can be found in company law statutes that allow corporations to make charitable contributions of a reasonable amount.\footnote{See e.g., Del Code Ann, Tit, 8, 122 (9) (1988).}

Alternatively, they may in fact argue that shareholders will benefit (even if only in the long run) from the conduct in question.\footnote{See, e.g., Kelly v Bell 266 A. 2d 878, 879 (Del. 1970) (a case from the State of Delaware/U.S.A.).}

On the other hand, and like corporation communitarian theorists, corporation concession theorists have legitimised the ultra vires doctrine, though providing different reasoning for its application. The view held by corporation concession theorists is that it is a necessity for the state to impose the ultra vires doctrine. This is because according to corporation concession theory, when a body is delegated...
powers and granted discretions, it may not go beyond these powers or fetter its discretions. In fact, the insistence of corporation concession theory to advocate implementing the *ultra vires* doctrine was mainly to protect stakeholders, such as creditors and shareholders, rather than hindering corporations from accumulating power.

The courts also developed a body of common law to govern corporate acts in providing protections to stakeholders that exceeded the powers conferred by the state. For example, in *Re Rolus Properties Ltd & Another* it was stated:

> The privilege of limited liability is a valuable incentive to encourage entrepreneurs to take on risky ventures without inevitable personal total financial disaster. It is, however, a privilege which must be accorded upon terms and some of the most important terms that Parliament has imposed are that accounts be kept and returns made so that the world can, by referring to those, see what is happening. Thus, a total failure to keep statutory books and to make statutory returns is significant for the public at large and a matter which amounts to misconduct if not complied with and is a matter of which the court should take account in considering whether a man can properly be allowed to continue to operate as a director of companies, or whether the public at large is to be protected against him on the grounds that he is unfit, not because he is fraudulent but because he is incompetent and unable to comply with the statutory obligations attached to limited liability. In my view that is a correct approach and the jurisdiction does extend and should be exercised in cases where a man has by his conduct revealed that he wholly unable to comply with the obligations that go with the privilege of limited liability.

The quote above provides, in the opinion of the court, a very clear demonstration of the link between doctrines of corporate separate legal entity, limited liability and *ultra vires*.

Another example can be found in the case of *Sutton's Hospital*, where Edward Coke conceived the company as an invisible being, which was created by the state only for legal purposes. In the American case *Dartmouth College v Woodward*, Chief Justice Marshall viewed the corporation as an invisible ‘artificial being’; distinct from its shareholders, which can sue and be sued independently. One could argue that in large corporations, the doctrine of *ultra vires* could provide protection

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67 (1988) 4 BCC 446.
68 (1612) 10 Co. Rep. 1a.
69 17 USA (4 Wheat) 518, 636-37 (1819).
to shareholders too. This is because shareholders, in a country where the doctrine of *ultra vires* is observed, could use it to tie the hands of company controllers. Yet, statutes relative to corporations have tended to protect other market participants, such as creditors, from shareholders' abuse of limited liability, which comes from the doctrine of separate legal entity of the company. Hence, under I.A. '1986, for example, corporations' controllers, in some cases, could be denied protection attached to the separate legal entity of corporations and limited liability (see ss. 213-217 I.A. '1986).

The influence of corporation concession theory began to appear in the statutes and common law on both sides of the Atlantic in the latter half of the 19th century. This indeed eased company regulations, providing a more attractive investing environment for shareholders. In the U.K. as well as the U.S., the application of corporation communitaire theory/public law to companies’ regulations, started to decline. States perceived their role as facilitating the function of corporations to trade with limited liability. Towards the beginning of the twentieth century concession theorists began to move away from the perception of the state’s interference in corporations. For example, in the 1920s, most U.S. states began to depart from the strict interpretation of the doctrine of *ultra vires*. In addition, competition replaced the notion that the state directly regulated and balanced the economic power of companies in accordance to the state’s needs. Therefore, corporation law lost much of its public character and in developing its private law aspect, came closer to relying on private citizens’ initiatives, as a means to creating corporations.

Generally, it is true to say that U.K. company law was and still is, greatly influenced by corporation concession theory. The legal status of shareholders is not at all an exception to this. Shareholders today, by and large, particularly the shareholders of companies other than the listed company, enjoy, at least in theory, a reasonable status under such a theory. The trouble, and based on the fact that concession theory justifies state intervention on the grounds of creating sound corporate governance, is that the state could interfere to make the status of shareholders worse, as well as better. As for reading the current Companies Act, and even the Company Law White
Paper 2002, there is clear evidence of the influence of concession theory, in trying to achieve a reasonable status for shareholders. For example and as mentioned above, in theory at least, the courts and legislatures intervened to enhance shareholders’ status, if they were to be oppressed by company controllers.

Generally speaking, shareholders accordingly, are placed at the heart of corporations, equipped with the power to hold corporate managers to account, through the constitutional machinery of corporations. Yet, although corporations’ constitutional machinery and balancing the power between the board of directors and the G.M. might work in small to medium size companies, it is difficult to apply in larger corporations. This is mainly because of the dispersion of share ownership among a significant number of shareholders. Nonetheless, the attractiveness of corporation concession theory is that it accommodates for the characteristics of contemporary companies. The move away from state interference in corporations, viewing the role of the state to be a mere facilitative role, has brought concession theory closer to contractual theory of corporation. Corporation contractual theory is thought however, to provide a more attractive model for shareholders. This is because it provides shareholders (those willing and able) with bargaining powers to contractually protect themselves from the potential abuse of corporate managers.

As mentioned above, there are many versions of corporation concession theory. Some argue for the managerial approach of corporations, which could be considered as a theory by itself. The fact that emphasis has been placed on the managerial approach of corporations, arguing against the primacy position of shareholders in corporations, entails that an association can be made to both corporation concession theory and corporation communitaire theory. However, this connection is closer to corporation concession theory, for the mere fact that it ignores the public approach to corporations. It rather uses the concept of the corporation as a legal entity as a means to an end, that places corporate managers at the heart of the company. This is because they are perceived as the agents for

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70 i.e., the notion of shareholders’ limited liability; the separate legal entity theme; and the perpetual duration of corporations.

71 See discussion below in this chapter.
corporations, rather than any particular interest group of the firm. The next section examines the corporation managerial approach in more detail.

### 3.4.1 Managerial Approach of Corporations

In the U.K., during the 1960s and 1970s, shareholders behaved increasingly as passive investors, who sought only a minimal return for their stocks. Throughout this period, private/individual investors lost their bargaining powers, which would help in monitoring and holding to account corporate managers. This was due to the change in private investors' ownership structure, from holding large shareholdings and family owned shareholdings, to small shareholdings that were largely dispersed. Moreover, there was no single financially viable group to take over the role of monitoring and holding to account corporate managers from private/individual shareholders.

Due to these factors, the question addressed by some legal scholars was: do shareholders have the ability to literally apply the aggregate theory, using the so-called 'bilateral contract' to negotiate protective contract terms? Or, is it the case that large corporations have lost shareholders' bargaining powers, which once helped to explain the so-called 'rhetoric of contract'? Investors' passivity or apathy made corporate management semi-autonomous; only engaged in 'satisficing' (i.e., earning a satisfactory profit, and not maximum profit) through a low risk, more controlled and less speculative investment in the corporation. On the other hand, legal scholars also raised the issue of whether corporate charters could explain

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73 i.e., an agreement in which the parties exchange promises for each to perform an action in the future, e.g. when a corporate manager agrees to carry out a particular task and investors agree to reward him for the agreed service. Both parties are bound to act and either will be in breach of contract if he does not.

74 See the use of the rhetoric of contract to explain corporation below.


the nature of those large corporations. The response to this question was ‘no’; the state rarely interfered with the way corporations were run.

Subsequently, as an alternative, a stream of managerialist legal scholars accepted the view that perceiving large corporations as private property had disappeared; was no longer applicable; was no longer a common belief; and, was never to return again. Though, according to some managerial theorists, separation of ownership and control is not necessarily a bad thing. In fact, they argue that separation of ownership and control is a perfectly sensible division of labour. This is particularly because that such a division entails that those investors, who would usually have no experience in management but have the capital power, submit their capital to experienced corporate managers, who on the other hand, alone, may lack the capital power; to proceed with their business idea.

Managerialist legal scholars looked again at the internal functioning of large public listed companies, and surrendered to the phenomenon of corporate management domination. However, corporation managerialist scholars still demanded that corporate managers should concentrate on the social responsibility of corporations, largely perceiving them to as representatives of the public. Such theorists, by and large, borrowed from the natural entity theory to justify their approach of corporate social responsibility. Furthermore, much emphasis was placed on the fact that corporation managers are trustees of corporations. The fact that managers are


trustees, place them under the obligation to act as such. Otherwise, managers risk legal liability if they fail to achieve what is expected from them, in the position of trustees.

Such an analogy may be somewhat sound. Yet, a good legal framework is needed to ensure that it works. In reality, and as mentioned in chapter one of this thesis, in the U.K., the courts are very reluctant to interfere with the running of corporations or interfering with business judgment. Directors' duties are not easily understood. Moreover, the British culture is not a litigious one. Relying on the law of trust aided by the fear of legal liability does work with good directors. It is naive, however, to think that relying on the law of trust and the fear of potential legal liability is always going to deter corporate managers from abusing their position. Furthermore, underestimating the position of shareholders does not help in solving the problem. Hence, some corporation managerialist theorists reflected on this by implying that the interests of shareholders should actually be taken into account somewhat. Consequently, they for example, suggested that corporate social responsibility would ultimately benefit shareholders in the long run, adopting a similar approach to natural entity theory.

Thus, one could argue that the managerial approach to corporations, not only acknowledges the dominance of corporate managers in listed companies, but also believes that such dominance would still be, as far as corporations are concerned, beneficial. Despite the effort of some managerial theorists to emphasis the duties of corporate managers to shareholders, they failed to demonstrate how such a system could actually work. Contractual theorists, in contrast, made shareholders the focal faucal of their argument, stating that it is actually shareholders who ultimately create companies and hence they could, by means of their contractual powers, provide

79 See the earlier discussion in this chapter.
80 e.g., R. Solomon and K. Collins, 'Humanistic Economics: A New Model for the Corporate Social Responsibility Debate', (1987), Journal of Corporation Law, 331. Solomon & Collins divided corporate social responsibility into three models: the pure market model which is related to aggregate theory; the moderate model which is related to natural entity theory; and, the pure political and humanistic approach models that are related to artificial entity theory.
themselves with protections against possible abuse from company controllers. The next section examines contractual theory in some depth.

3.5. Corporation Contractual Theory

The tendency to ease company regulations and deem privatisation as an 'efficient' way of running utilities, gave some theorists in the latter half of the 19th century, the momentum to argue that the corporation is a contract between contractual parties. This move of course, represented the extreme opposite to the approach of corporation communitarian theorists. Corporation contractual theorists argue that the company is a mere contract between shareholders. Hence, shareholders as contractual parties are the sole creators of corporations.

Contractual theory gives shareholders the freedom to apply the legal maxim; 'the contract is the law for contractors'. Indeed, via such a description, contractualism theorists were referring more to private, rather than large listed companies. Therefore, it is apparent that corporation contractual theory clearly challenges the theme of 'corporate personality', which is of course the core of both, corporation communitaire theory and corporation concession theory. However, contractual theory is indeed very favourable, from the point of view of corporate promoters. This is because, contractualism saves promoters from worrying about pre-incorporation contracts, before the corporation is even established as one, as well as the fact that they may be held personally responsible for such contracts, if not approved by the corporation.

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81 See, D. Millon, 'Theories of the Corporation', (1990), Duke Law Journal, 201; also, M. Philips, supra, n 2, at 240, who argues that this theory dominated the legal discourse early in the 20th century.

82 This approach was later given the name of 'aggregate theory'. Labelling contractualism theory as 'aggregate theory' might have been initiated by J. Coates, supra, n 1.

83 This is an ancient legal maxim but attributed to the French Civil Code nowadays. This maxim is referred to in English contract law as 'freedom of contract'. See, M. Stokes, supra, n 33, at 162.

84 C. Riley, supra, n 5, at 782.

85 For a good source on pre-incorporation contracts see P. Davies, Gower and Davies Principles of Modern Company Law, (Sweet & Maxwell, London, 2003), at 99-102.
Nonetheless, apart from shareholders and promoters, contractual theorists ignore all other parties; such as creditors, employees, managers, society and the environment. For contractual theorists, giving shareholders such a role in companies is justified on the basis that they are the risk bearers, i.e. their investments are potentially exposed to a complete loss. Hence, for contractual theorists, the fact that shareholders provide capital for corporations, places them in a position to collectively claim its ownership. Shares give shareholders the right to take part in decision making, sharing the company’s profit and possibly obtaining some of the company’s assets in case of liquidation, for example.

According to Sami, the origin of this theory can be traced as far back as the ancient Sumer Civilisation (the people of ancient Babylonia). More recently, the French Civil Code, since the very first version of Napoleon in 1804, had been fascinated by the idea of the company as a contract, rather than as a charter. Hence, the French legislators did not recognise the state’s involvement in establishing a company.

Article 1832 of the French Civil Code (85-697 of 11 July 1985 as amended) states:

\[\text{Alinea 1. A firm is established by two or several persons, which agree by a contract to appropriate property or their industry for a common venture with a view to sharing the benefit or profiting from the saving which may result therefrom.}\]

\[\text{Alinea 2. It may be established, in the cases provided for by statute, through an act of will of one person alone.}\]

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86 Sami for example claims that there is evidence to suggest that by 3000 BC the Sumerian’s civilisation in Iraq had a system in which to register company contracts. See, F. Sami, supra, n 1, at 11.

87 The Napoleon Code or the French Civil Code was decreed 8 March 1804 and promulgated the 18th of the same month. The French Civil Code was literally translated from the original and official edition, published in Paris, in 1804 by a barrister of the Inner Temple. The translation has been attributed to George Spence (cf. Cushing's Anonyms: A Dictionary of Revealed Authorship and Halkett & Laing's Dictionary of Anonymous and Pseudonymous English Literature and in the Dictionary of National Biography).

88 The French version of the article states:

\[\text{‘Alinea 1 La société est instituée par deux ou plusieurs personnes qui conviennent par un contrat d’affecter à une entreprise commune des biens ou leur industrie en vue de partager le bénéfice ou de profiter de l’économie qui pourra en résulter.}\]

\[\text{Alinea 2 Elle peut être instituée, dans les cas prévus par la loi, par l’acte de volonté d’une seule personne.’}\]
It should be noted that the original Napoleon Code only mentioned partnership, and there was no mention of companies as contracts. Yet, practically speaking, companies were included. The reason that the Napoleon Code did not mention the word ‘companies’ was to avoid conflict with Article 1 of Loi Le Chapelier. \(^\text{89}\) This is because, Article 1 of Loi Le Chapelier which was established because of at the time of the French revolution, had come into force on 14 June 1791, deeming all groups including corporations, void. In fact, Article 1 of Loi Le Chapelier states that corporations do not exist at all anymore. Such strong expression in the Loi Le Chapelier was to show the revolutionists strong determination to fight monopolies and consequently aristocrats. Before the French revolution, it had been the case that in order for an individual or a group of people to practice a profession or a trade, they had to obtain approval from the association to do so. Those associations were called corporations and/or societies. The fear that corporations would accumulate great power and the risk of such corporations monopolising the market, prompted the Loi Le Chapelier to prohibit all kinds of aggregations, including companies.

It is interesting that during this era, both the French and the British feared the power of corporations and hence, tried to control them. Yet, the approach of reining in corporations was very different on both sides of the English Channel. The British approach was dominated by artificial entity theorists, in their emphasis on the public approach to corporation law. This entailed restraining companies from accumulating political power; treating corporations as an instrument in the hands of the state, serving the state to achieve better welfare for society. The French approach however, was rather like, ‘killing the goose that lays the golden eggs’. It appears that at the time, the French felt extremely passionate against the existence of the corporation. This was so much so that if corporations did not exist as contracts, then they were prevented from existing at all. The British on the other hand, did not object to implementing elements from a number of different theories of the company, with special emphasis at the time on corporation communitaire theory. In doing so, legislators aimed to serve both the needs of businesses, as well as society.

\(^{89}\) Article 1 of Loi Le Chapelier states: ‘L'anéantissement de toutes espèces de corporations des citoyens du même état ou profession étant une des bases fondamentales de la constitution française, il est défendu de les rétablir de fait, sous quelque prétexte et quelque forme que ce soit.’
Clearly, Article 1832 of the French Civil Code fails to take notice of the state’s involvement in corporations. Instead, Article 1832 of the French Civil Code gives all the credit of establishing corporations, to contracts between parties. In fact, even the current French Civil Code remains steadfast to contractualism as a theory of creating corporations. This is to such an extent that it even attempts to justify the existence of one-member companies on the basis of contract, or at least seeks to ignore the importance of the state’s concession to such a company. For the latter type of company, Article 1832 of the French Civil Code, entails that the creator of such a company is subject to the approval of a companies’ existence through criteria provided by the law. Hence, if a one-person company meets such criteria as set out by the law it would, based on intention of the person(s), become a corporation. Justifying one-person companies on the basis of contractualism is rather bizarre. This is because it is a sole initiative, rather than an aggregate of persons, that creates the company. Indeed, it is rather hard to justify that one could have a contract with ‘himself’. Yet, knowing that such a justification is peculiar, the French Civil Code did not state clearly whether a one-person company is or is not a contract. Instead, the French Civil Code emphasises prerequisites for incorporating one-person companies, stating that when those prerequisites exist, the company will exist and be registered. Hence, the French Civil Code applied concession theory to one-person companies.

There are many criticisms directed at the contractual theory of corporation. For example, some may find it difficult to explain the three main characteristics of corporations, (namely: the notion of shareholders’ limited liability; the separate legal entity theme; and the perpetual duration of corporations), when applying contractual theory.90 Yet, some contractual theorists have tried vividly to explain those three characteristics contractually91 For example, contractual theorists explain the notion of limited liability by purporting that it is derived from implied contracts between shareholders through the board of directors and creditors. Moreover, Berle and Means for instance, declared that:

90 See, M. Horwitz, supra, n 37, at 183.
91 See in particular, A. Hessen, supra, n 40, at 1331-1336.
A clause could be put in every contract by which the opposite party [e.g., creditors] limited his rights of recovery to the common fund: the incorporation act may fairly be constructed as legislating into all corporate contracts an implied clause to that effect.\footnote{92}{A. Berle and G. Means, supra, n 53, at 120.}

The view taken by Berle and Means is true in the sense that creditors could insist, (and they sometimes do), on extending the notion of limited liability to include corporate controllers’ personal liability. Moreover, contractual theorists have attempted to dissolve the corporate separate legal personality by the ingenious perception of a corporation as a web or nexus of contracts.\footnote{93}{See for example, Baysinger and Butler, ‘The Role of Corporate Law in the Theory of the Firm’, (1985) 28, Journal of Law and Economy, 179, at 179. The ‘nexus of contract’ is discussed further below.} This is developed by neo-economic theorists and explained in some depth below.

In the U.K., the extent to which this theory is applied to shareholders’ legal status is not particularly clear. Section 14 C.A. ‘1985 for example, states that a company’s memorandum and articles, bind both the company and its members. Yet, it continues by stating that a contract is binding, implying that it should be signed and sealed by each member, without mentioning the company itself.\footnote{94}{The statutory contract which is set out in s. 14 C.A. ‘1985 reads as follow: ‘Subject to the provisions of [this Act], the memorandum and articles, when registered, bind the company and its members to the same extent as if they respectively had been signed and sealed by each members, and contained covenants on the part of each member to observe all the provisions of the memorandum and of the articles.’} This approach seems to ignore the fact that a company is a separate legal entity to its shareholders. In \textit{Wood v Odessa Waterworks},\footnote{95}{(1889) 42 Ch D 636 at p. 642.} Stirling J declared that the: ‘articles of association constitute a contract not merely between the shareholders and the company, but between each individual shareholder and every other.’

One further ambiguity of the application of this theory comes from the fact that, and unlike an ordinary contract, altering the company contract does not need the consent of all parties. Section 9(1) C.A. ‘1985, provides: ‘[s]ubject to the provisions of this [Act] and to the conditions contained in its memorandum, a company may by special
resolution alter its articles.’ Hence, if 75% of shareholders, present at a meeting decide to alter the company’s articles, such a decision would bind the remaining minority who clearly object to such an alteration.

The fact that shareholders can alter the company’s constitution raises the question of whether shareholders can use such a method to provide themselves with more protection from the potential abuse of company management in U.K. listed companies. The extent to which investors see the company constitution relevant in providing them protection is not clear. Whether or not investors use publicly available information, such as the company’s constitution, to find out whether they are enjoying enough protection or not, was one of the questions that this study addressed. Accessing public sources of information that clarify shareholders’ legal status in the company is very important since it must be the first step in addressing potential changes needed for shareholders to provide themselves with more protection. Hence, this study embarked on collecting empirical evidence to examine whether shareholders use publicly available information to find out whether they enjoy enough protection or not, and if not, can they negotiate more protective terms in the company. This is the subject of discussion in the next section, entitled ‘Investor Self-help – The Claim that Shareholders Could Negotiate More Protective Legal Terms ‘Prevention is better than Cure’”.

As mentioned above, corporation contractual theory was further criticised for its simplistic approach of only acknowledging shareholders and company managers, which in a sense makes the theory more applicable to small private companies. The managerialist approach however (discussed above in this chapter), which focuses on the problems that are created by the existence of hierarchies within corporate structures and by the imbalances of power in the operation of company affairs, was and to some extent still is, the dominating approach to large listed companies.96 This is attributed to separation of ownership and control within corporations.97

96 C. Riley, supra, n 5, at 782–783.
97 A. Berle, and G. Means, supra, n 53.
In addressing these problems, contractual theorists developed the so-called ‘new economic theory of corporation’, which pictured the company as a web of contracts amongst all its actors, collectively joining efforts to produce output. This approach necessarily weakens the status of shareholders, since it distributes the focus on many groups, rather than keeping it solely on shareholders. Therefore, one could argue that the foundation of the new economic theory is still similar to the traditional contractualism approach in that they both perceive the company as residing in the contractual relationships between corporation’s parties. Yet, the main difference between them is that legal contractualism has a greater plasticity, allowing notions of reasonableness and equity to be deemed as matters at the heart of a contract. Consequently, this allows other stakeholders to enter into the equation of the corporation.

In purporting to have addressed actors other that shareholders and managers, the new economic theory of corporation has managed to give some recognition to other parties. This, according to the new economic theory, is not only important in corporations which perform business as usual, but is also just as important when corporations go under reconstruction, for example. The idea of introducing a nexus contracts in corporations other that shareholders and managers, is to include those actors equally needed for the continuation of a corporation, as well as providing protections against corporate managers that use their extensive authority to abuse the corporation in which they work. Thus, the idea is to provide protections to the actors of those corporations, against the abuse of corporate managers. This has resulted in the introduction of a huge amount of legislation, which addresses the protection of each individual actor within corporations.  

Hence, the new economic theory came to the forefront as a legal theory of corporation. The next title is wholly dedicated to discussing the philosophy that this theory adopted as a sub-theory of the contractual theory.

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98 C. Riley, supra, n 5, at 783; see also the discussion in chapter one of this thesis on how laws have dealt with the protection of those different actors, such as in environmental law, employment law, etc. Yet, company law left the issue of accountability ultimately in the hands of shareholders.
3.5.1. The New Economic Theory of Corporations

The new economic theory remained steadfast to the belief that shareholders are the creators of corporations, rather than the state. As one new economic theorist, Cheffins, for example states:

[...] even without laws providing for incorporation, business enterprises can be organized along much the same lines as the modern corporation. It follows that companies legislation has had in and of itself only a modest impact on the bargaining dynamics which account for the nature and form of business enterprises. Thus, analytically an incorporated company is, like other types of firms, fundamentally, a nexus of contracts.  

In addition, and as a consequence of considering the contract between shareholders to be the creator of corporations, the notion of the corporation’s separate personality to those who founded it, was almost ignored. Moreover, the new economic theory of corporations, failed to explain the doctrine of limited liability. However, rather than accommodating for these doctrines, some new economist theorists tried to undermine them. For example, some new economist theorists weaken the status of the doctrine of limited liability by stating that it is a mere incentive for investment by the state. Instead, the new economist theorists have concentrated on the role of the market in ensuring a good corporate governance system, whilst underestimating the role of the state in interfering with companies. In the view of new economist theorists, state intervention in corporations should be limited to altering any market imperfection, to recreate a better market.

The new economic theorists of corporations do not however, agree on the role that the state should play in interfering with the market, by providing laws and regulations. There are two main views on the role of the state with regards to its interference in the running of companies. One stance on the state’s role is that it exclusively enables companies to carry out their business. However, it should be noted that this standpoint can literally be considered as the equivalent to the mildest form of corporation concession theory. Therefore, at least on this point, the new

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100 G. Teubner, supra, n 30, at 130.
economic theorists of corporations agree with corporation concession theorists on the role that the state should play in relation to corporations. As new economic theorist Ballantine, for example, argued:

The primary purpose of corporation law is not regulatory. They are enabling Acts, to authorise businessmen to organise and operate their business, large or small, with the advantage of the corporate mechanism. They are drawn with a view to facilitate efficient management of business and adjustment to the needs of change.102

The other view held by some theorists is more excessive in perceiving the role of the state, not only as one which enables companies to function, but also that it is inevitably both limitative and empowering to corporations in the way they perform business. This position overspills to concession theory of corporations, as highlighted by the work of Greenfield, who argues:

One would not suggest [...] that Eastern European Nations recently freed from communism would succeed an economic powers simply by having the government completely disentangle itself from the economic decisions of its citizens. On the contrary, one would start with putting in place a set of basic rules of economic interactions, supplemented with a system of contract and property entitlements that individuals could negotiate around. One would also seek to guarantee that disputes could be resolved fairly.103

Although the new economic theory of corporations seems to have retracted from exclusively perceiving the corporation as a contract between shareholders (as the view of corporation contractual theory), it still provides a good status for shareholders. Yet, it must be recognised that emphasis is also placed on the role of all other stakeholders, although addressing these roles is not directed at weakening the status of shareholders. It is rather meant to provide enough protection to all stakeholders from corporate managers. For example and as demonstrated in Greenfield’s quote above, some new economic theorists of the corporation justify intervention by the state in the running of corporations as a means by which to protect stakeholders, where the web of contracts fails to do so.

The other focal argument of the theory is to explain managerial behaviour as well as adopting the view that free markets are the most effective system in reining in

103 K. Greenfield, supra, n 9, at 19.
corporate managers. Yet, the claim that free markets are the most effective system in reining in corporate managers is fundamentally based on the assumption that individual market players bargain with full information.\footnote{104} Furthermore, the theory imagines that market players would use the ‘efficient information’ available to make ‘rational’ decisions. As far as the rationality of a decision is concerned, it could be argued that a person would be acting rationally if s/he enters into a bargain in which s/he would benefit. This necessarily means that in a sales transaction, both parties, if acting rationally, will benefit both themselves and therefore, society at large.\footnote{105} However, economists do not agree on the meaning of efficiency or rationality. For example, Pareto’s version of efficiency, for example, necessitates that someone gains and no one loses.\footnote{106} Kaldor-Hicks, on the other hand, views efficiency as, ‘a policy, which results in sufficient benefits for those who gain such that \textit{potentially}\footnote{107} they can compensate fully all the losers and still remain better off’.\footnote{108}

The economic theory of the corporation also offered an explanation to managerial behaviour. Perceiving corporations as a set of contracts (nexus-contracts), the relationship between shareholders and corporate managers is characterised to be of utmost importance in nexus-contracts. The roots of this theory can be traced to Coase’s thesis, published in 1937.\footnote{109} The work of Coase focused on internal economic transactions as a method of cost saving, compared to market transactions. Transaction costs are reduced by the organisational design of a company. Thus,

\footnote{104}{\textit{B. Cheffins, supra, n 100, at 6.}} \footnote{105}{\textit{J. Dine, supra, n 8, at 9, quotes an example provided by Ogus: ‘Bill agrees to sell a car to Ben for £5,000. In normal circumstances it is appropriate to infer that Bill values that car at less than £5,000 (say £4,500) and Ben values it at more than £5,000 (say £5,500). If the contract is performed, both parties will gain £500 and therefore there is a gain to society – the car has moved to a more valuable use in the hands of Ben […] this is said to be an allocatively ‘efficient’ consequence.’ A. Ogus, \textit{Regulation: Legal Form and Economic Theory}, (Clarendon Press, Oxford, 1994).}} \footnote{106}{\textit{Not accessed directly; rather from, J. Dine, supra, n 8, at 9.}} \footnote{107}{\textit{Italics in the original text.}} \footnote{108}{\textit{J. Dine, supra, n 8, at 9.}} \footnote{109}{\textit{R. Coase, ‘The Nature of the Firm’, (1937) 4, \textit{Economica}, 386.}}
Coase saw companies as a means of reducing the costs of a complex market, consisting of a series of bargains among different parties.\textsuperscript{110}

Being an economist, Coase’s main concern was the company’s relevant actors, rather than the issue of regulating the company. In support of Coase’s view, Greenfield dismissed the importance of regulations in shaping companies, stating that:

Corporate law establishes a set of-the-rack legal rules that mimic what investors and their agents would typically contract to do. Most shareholders, it is assumed, would contract with the business managers to ensure that the managers seek to maximise profit.\textsuperscript{111}

According to this theory, the relevancy of laws and regulations, such as company law, are seen as a utility to reduce transaction costs; preventing high costs being applied to every individual bargain related to a company with those persons involved (i.e., avoiding paying for the same utility repeatedly by different market players). Hence, company law is supposed to provide sound corporate governance and reduce transaction costs by forming corporations according to a standard corporation charter. Such a charter ensures the standardised sets of ‘rights’ which shareholders could be expected to insist upon. For example, shareholders would wish to be able to appoint and fire management and hold them to account. Hence, the fact that those rights are standardised in the charters should result in reducing the cost of individual bargaining.\textsuperscript{112}

The same reasoning was used by the ‘neo-classical economic theory of the corporation’ (see discussion below); an adaptation of the new economic theory of corporation. This theory is used to explain the law’s intervention in placing duties on directors. This is because directors may have a conflict of interests with shareholders


\textsuperscript{111} K. Greenfield, supra, n 9, at 10.

and are likely to try and divert the company’s resources to themselves. As a result, shareholders would be prompted to use the free bargaining position available to them to demand more protective terms in the corporate charter.\textsuperscript{113} Furthermore, the theory sees the court’s interventions in the business of corporations as imposing implied terms on the contract between shareholders.\textsuperscript{114} The only other reason for laws and regulations, according to this theory is that markets could be imperfect. Hence, laws and regulation could have a role to play in bridging any ‘market failure’, to allow markets to function perfectly.

The new economic theory of the firm was developed and refined later on by Alchian and Demsetz\textsuperscript{115}, which then went under further development and expansion by Jensen and Meckling.\textsuperscript{116} For example, Alchian and Demsetz and Jensen and Meckling disagreed with Coase’s rejection of the concept of shareholders as the company’s owners, perceiving them as mere contractors among various groups of contractors that could define and constitute the corporate enterprise. Yet, they still describe management’s role as shareholders’ agents, giving the right to the latter to draft and supervise the process of preparing agreements and taking into consideration the other actors who participate in the firm’s activities.

Assuming that controllers act to maximise shareholder’s financial interests, there is always a risk that management might fail to do so. The costs associated with this risk are called ‘agency costs’.\textsuperscript{117} Agency cost composes of: (1) monitoring costs by

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\textsuperscript{114} See J. Dine, supra, n 8, at 10.


\textsuperscript{117} It is worth noting here that originally, the new economic theory of the firm was developed independently of and in parallel with the ‘agency theory’. The similarity between these two theories lies in the explanation of the problem that shareholders are faced with in monitoring corporate managers. See, A. Alchian and H. Demsetz, supra, n 115; and M. Jensen, and W. Meckling, supra, n 116.

The relationship between ‘agency theory’ and the new economic theory of the firm can be classified as follows: while agency theory correlates the phenomenon of
the principal to control and observe the agent’s behaviour, (2) bonding costs by the principal to ensure that the agent will not take actions to harm the principal’s interests, and (3) the residual loss which represents the difference in actions between the agent and principal, if the principal takes the action upon himself. Unlike creditors and others company contractors, who can only come with fixed claims against corporate revenue, it is shareholders who ultimately bear these agency costs. Therefore, if the set of contracts that makes up a firm fails to minimise agency costs, it is only shareholders who pay those costs. This is basically because buyers will pay less for the stock and as a result, distributions or liquidation proceeds, which would be lower than if under more efficient management.

Motivated by market forces, (including pressures from the capital, management, labour, service, and corporate control markets) there are incentives for managers to minimise agency costs. Although the new economic theory of the firm was developed independently from the managerial approach, what they do have in common is the concept of the hierarchical structure of the firm. Put simply, both approaches locate management right at the heart of modern large corporations. The new economic theory of the firm states that corporate managers, who have generally obtained the managerial skills and ability, but lack the wealth, team up with investors (other persons) who possess the wealth, but generally lack the ability and skills to form an enterprise. To this theory, the phenomenon of the divorce between ownership and control in the British and American markets is rather the divorce between ownership and control in large modern British and American corporations with the problem of agency cost, the neo-economic theory of the firm draws on the same phenomenon from the point of view of the relationship between corporate managers and shareholders.

Managerial theory consists of three main aspects: (i) that corporate management decides on the corporate process of production and distribution; (ii) corporate management rules hierarchical bureaucracies, exercising their authority and power over those who are lower in the hierarchy; and (iii) corporate management govern corporations as entities, imposing externality on those outside the entity. See for example, E. Fame and M. Jensen, 'Separation of Ownership and Control', (1983) 26, Journal of Law & Economy; and R. Nader, M. Green and J. Seligman, supra, n 3.

efficient response of those markets' economic forces. In general, following on from Jensen and Meckling's addition to the new economic theory of the firm, neo-economic theorists became more focused on the internal operation of the firm. However, the new economic theory of the firm developed into two variants, namely: neo-classical economic theory and institutional economic theory.

3.5.1.1 The Neo-Classical Economic Theory of the Firm

The neo-classical economic theory (also called property rights theory) perceives the corporation as a legal fiction that operates as a nexus for a set of contracting relationships among individuals. Those series of contracts are simply joining inputs to produce an output. Thus, the contractual nature of the firm, which originates from aggregate theory, lies at the heart of the neo-classical economic theory. Furthermore, agency theory is used in this theory to explain the relationship between shareholders and corporate managers, particularly the conflict of interests between these two groups within a corporation.

The phenomenon of the conflict of interests between principal and agent is neither new nor limited only to the agency relationship in a corporation. For example, over two hundred years ago, Smith stated:

[...] seldom pretend to understand anything of the business of the company; and when the spirit of faction happens not to avail among them, give themselves no trouble about it, but receive contently such half yearly or yearly divided, as the directors think proper to make them. The directors of such companies, however, being managers of other people's money than with their own, it cannot well be expected, that they should be should watch over their own.... Negligence and profusion, therefore must always prevail more or less, in the management of the affairs of the company.

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122 M. Jensen, and W. Meckling, supra, n 116, at 310.
123 ibid. at 310-311.
The agency problem applies to any agent/principal relationship. The problem is that an agent might have less incentive to enhance his or her principal’s interests, than if the principal was carrying out the delegated task himself. This is called shirking. The suggestion has been made that shirking occurs in modern large corporations because managers would normally have no or very little investment in the corporate that they manage. Furthermore, corporate managers as a group in the company might pursue their own interests such as claiming high remuneration packages. Hence, such behaviour by corporate managers would create agency costs.

In general, agency costs that occur within a large modern corporate because of the divergence of interests between corporate managers and shareholders, can be divided into two different sources: (i) the difference between corporate results, measured by capital gains and dividends and the maximum shareholders would have gained if managers have acted as owners; and (ii) the costs that are inflicted on shareholders as a result of monitoring corporate managers. According to the neo-classical economic theory of the firm, however, management would still seek to minimise agency costs. This is mainly because of the influence of the capital market which entails that, the more the agency costs experienced by a company, the lower its price of shares (i.e. agency costs would reflect negatively on the price of shares), in the process of public trading of corporate shares. Hence, corporate managers will control agency costs to convince investors in a corporation that they offer the highest returns for their capital.

3.5.1.2. Institutional Economic Theory of the Firm

Like neo-classical economic theory, the institutional economic theory of the firm considers the firm to be a series of contracts; explaining the firm’s structural features as the cost-saving devices of transacting parties. Institutional economic theory of the firm, however, recognises that a firm is a single profit maximising unit and as an
entity, it constitutes a hierarchical structure. This theory accepts managerial opportunistic conduct in a corporation, attributing it to human failings within the corporation. Furthermore, this theory states that markets exchanges could not offer a solution to such problems (i.e. human failings), distinguishing between a corporation and the market, despite the fact that they are both of a contractual nature.

After discussing the theories of the corporation, one can deduce that the contractual theory of corporation and consequent developments by the new economic theorists, intended to offer shareholders some contractual powers, to negotiate a better legal status for themselves with corporate managers. Yet, and as far as shareholders in public listed companies are concerned, for the good intention of contractual theorists to work, shareholders need to have adequate knowledge about the existing legal rights that they enjoy in the companies in which they invest, in order to be able to negotiate a better status for themselves. The next section presents some empirical insight concerning institutional investors' and investment managers' awareness of negotiating power with corporate managers, and the benefits negotiating might entail.

3.6. Investor Self-help – The Claim that Shareholders Could Negotiate More Protective Legal Terms ‘Prevention is better than Cure’

This section examines empirical evidence to verify the claim that shareholders generally, and institutional investors and investment managers in particular, could negotiate more protective legal terms with the managers of public listed companies. This study defines the process of shareholders' negotiation for more protective terms with corporate managers, 'self-help'. The research conducted for this study provides some insight into the facts related to the validity of such a myth, arisen from the argument put forward by contractual theory in general, and the Economic Analysis of Law School, in particular. The perception of this school, is that company is a nexus of contracts and that the terms of its constitution are the basis agreed upon in which investors choose to become involved. Like many of their assumptions, it is

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129 O. Williamson, supra, n 124, at 294-297; see also O. Williamson, Markets and Hierarchies, (Free Press, New York, 1975); And O. Williamson, 'Transaction Cost Economics', supra, n 11.
a classical economic model, rather than the result of empirical observation. The argument put forward is that shareholders, especially institutional ones, can protect themselves by negotiating more protective terms, for themselves and consequently for other shareholders (including private ones) in the company’s memorandum and articles of association. For example, institutional investors could negotiate a term to be included in the company’s memorandum that limits the number of executive directors, whilst imposing a large portion of independent non-executive directors in the board of directors; and that a third impartial body take on appointing the non-executive directors.

Generally, and from a theoretical point of view, shareholders have the right to change the company constitution (memorandum and articles of association). Section 9(1) C.A. ‘1985 provides: ‘[s]ubject to the provisions of this [Act] and to the conditions contained in its memorandum, a company may by special resolution alter its articles.’ Likewise, the C.A. ‘1985 generally allows a company by a special resolution to alter its articles of association. Besides, in the U.K., institutional investors and investment managers are in a good position to negotiate the terms of company memorandum and articles of association.

Institutional investors and investment managers are, no doubt, and because of their capital power, usually in a better position than private shareholders to negotiate the

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130 There are various sections in C.A. ‘1985 that deal with the alteration of the company’s memorandum. For example, ss. 4-6 and 380 deal with the alteration of a company’s objects. Sections 28(1), (2), 31 and 32 deal with the alteration of a company name. Section 121 deals with changing the company’s authorised capital, etc.

It is worth noting that the C.L.R. (Modern Company Law for a Competitive Economy: the Strategic Framework, DTI 2001) has recommended a variety of changes to the current provisions in the Company Law that deal with company’s memorandum and articles of associations. The Government has accepted most of these changes in the Company Law White Paper (Modernising Company Law: Cm 5553-I, paragraphs 2.2, 2.3 and 6.2), and those changes include: (i) companies formed under the new legislation should have a single document for simplification, instead of having a separate memorandum and articles of association; (ii) the constitution could be alterable by a special majority. However, if all members agree a higher threshold for alteration or even unanimity, an alteration to the company constitution may be required; (iii) new companies would not be limited in capacity and if a company contains an object clause it would have an internal effect, i.e. between the directors and the company’s members.
terms of the company constitution, before investing in a company's shares. In theory, negotiations made by institutional investors' for more protective legal terms, can take place not only at the stage of forming a company, when the company needs to generate its capital, but also at a later stage by the legal means available to them through discussions of the terms on which shares are issued. This can even take place in the A.G.M. of the company, if constitutional amendments are required.131 The share ownership power vested in institutional investors would allow them to negotiate their legal terms if they have the will to do so, as long as it is not prohibited by legislation.132 Negotiating legal terms however, requires legal and managerial skills that are more likely to be found in institutional investors rather than individual/private investors. The U.K.L.A. Listing Rules are another source of rights, which add more to the basic rights of shareholders in listed companies as conferred by the C.A. '1985. The level of investors' interest in a particular company's shares, clearly affects its ability to raise capital and the cost of that capital.

In realising the importance of the role that institutional investors and investment managers can play in negotiating protective legal terms, one needs to ask whether institutional investors and investment managers have the will to negotiate for more protective legal terms. It is logical to assume that the first step towards changing the company's memorandum and articles of association is for one to know what it consists of and whether or not it provides the usual protections and recommendations as, for example, developed by the Combined Code. Therefore, this study enquired about the source(s) of information on which investment managers and institutional investors rely upon to ensure that the company memorandum and articles of association provide the usual protections and recommendations in the 'Code of Best Practice'. In the questionnaires distributed to both groups (institutional investors and investment managers), five options were provided in the question and respondents could provide a sixth source other than the five options

131 Section 9 C.A. '1985 provides the right to alter the company's memorandum and article of association by a special resolution.

132 e.g., C.A. '1985 bans companies from giving financial assistance to acquire their own shares.
part of the company's memorandum and articles of association; information provided in accordance with the stock exchange / statutory requirements; financial reports from newspapers or any type of media; N.A.P.F. or other associations' reports; and, market research sources, such as 'Jordan's Data Quest'.

There were high expectations that, since the institutions involved in the study, have the capacity to employ lawyers and financial analysts, they would be active in acquiring adequate information concerning the terms of the company's memorandum and articles of association. It is true that most companies would choose the standard company's memorandum and articles of association that is provided by Table A of the Regulations made under the Companies Act 1985. Nonetheless, one would have thought that institutional investors and investment managers would still want to make sure what they were signing themselves into, in case the corporate constitution did not provide enough protection for shareholders.

It is surprising that only 21.8% of institutional investors and similar figures of 21.4% of investment managers rely on the company's memorandum and articles of association as a source of information to make sure that the company provides the usual protections and recommendations in the 'Code of Best Practice'. The figures show a rather low tendency among institutional investors and investment managers to read the company's memorandum and articles of association, which leads one to think that if the figures are so low among institutional investors and investment managers, they might be even lower among private investors. This is because private investors do not usually have easy access to professional lawyers or financiers to analyse such legal documents. Table A, for example, as a widely used model by companies, is complex and would be difficult for a layperson to understand. The figures here suggest that shareholders generally (including institutional investors) do not have the will to negotiate a company's contract terms as expressed in its constitution. It has been suggested that even institutional investors have neither the expertise nor the willingness to bear the cost of such a process. The reason for such a low occurrence of reading the company's memorandum and articles of associations is not known for sure, though one could argue that it is unpractical to do so, in a
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Chapter Three

rapid and dynamic financial market, where many transactions of selling and buying are carried out by an institutional investor every day and where time is at a premium.

The above practical difficulties might lead one to think of the other four sources as identified by the questionnaire, namely: information provided in accordance with stock exchange or statutory requirements (i.e., the company annual report or listing particulars for a share issue); financial reports in the newspapers or any type of media; N.A.P.F. or other associations’ reports; and, market research sources, such as "Jordan’s Data Quest". Institutional shareholders and investment managers were asked whether they use the information provided by the stock exchange to know whether as investors, they are provided with enough protections. Such a source of information might be more appealing to shareholders since it is shorter and easier to understand. Although, there was an inclination to use this source of information in comparison with reading a company’s constitution, the percentage was still relatively low, especially because of the importance of the information that this source can provide. Only 31.7% of institutional investors and 50% of investment managers rely on information provided in accordance with stock exchange / statutory requirements as a source of information to ensure that the company provides the usual protections and recommendations in the ‘Code of Best Practice’.

Financial reports in newspapers or any other type of media was also not a popular source of information for institutional investors and investment managers, only 18.8% of institutional investors and 21.4% of investment managers of which rely on this source of information. It should be stated here that the low inclination towards using media as a source of information is hardly surprising. This is mainly because of the fact that, apart from reports of routine announcements through the Stock Exchange, the media is not a very good source in providing such information, unless something has already gone wrong within a company, by which time it might be too late for shareholders to be able to retrieve their shares, let alone negotiate more protective legal terms. It may also be the case that information supplied by the news media will be limited in scope and detail.
The most popular source of information for both groups is the reports provided by N.A.P.F. and the A.B.I. 45.5% of institutional investors and 57.1% of investment managers rely on NAPF or other associations’ reports to make sure that the company provides the usual protections and recommendations in the ‘Code of Best Practice’. The reason for the popularity of this source of information might be the fact that these associations do provide information about companies in an accessible and straightforward way. There is also the issue of trust between institutional investors and these associations. Furthermore, there might be an expectation from members of these associations that this sort of information will be provided by them in return for payment of the subscription fees by shareholders. The most unpopular source of information for both groups was market research sources, such as ‘Jordan’s Data Quest’. Only 5% of institutional investors and 7.1% of investment managers rely on this source of information. The most probable reason for the low inclination in using this source of information is its cost.133

Almost 31% of institutional investors, rely on external investment managers to make sure that the company provides the usual protections and recommendations in the ‘Code of Best Practice’. This figure is high, considering the fact that it was not a factor suggested in the five original possibilities given in the question. Other legal scholars, such as Stapledon, observed the importance of investment managers and the role that they can potentially play.134 The researcher in this study however, observed through informal conversation with some institutional investors, that there is the culture, particularly among small size institutional investors, to completely submit the management of their equity shares to investment managers. The only real concern of the institutional investor in this case is to look at the performance of their shares at the end of the financial year. Further to this, shareholders might make a comparison between the performances of other investment managers, in order to

133 Investment managers did not provide any other sources of information, whereas institutional investors provided three other sources of information; namely: relying on external investment managers, professional legal advice, and the company report and corporate governance report.

determine if they should change their investment manager, if it is the case that they are not in line with market performance.\textsuperscript{135}

Professional legal advice was another source of information that institutional investors provided as a method that they rely on to make sure that the company provides the usual protections and recommendations in the ‘Code of Best Practice’. The figures in no way suggest that this source of information is popular among institutional investors. Only 2\% of institutional investors rely on professional legal advice. Acknowledging the fact that using lawyers in the financial world can be very costly, it came as a surprise that some institutional investors rely on legal advice as a source of information. The mere fact that some shareholders rely on such a source is encouraging, since it might indicate an attempt to negotiate a change in the terms of the company contract, as expressed in the company memorandum and articles of association.

The company report / corporate governance report is another source of information that one institutional investor provided as a source of information that is relied on to make sure that the company provides the usual protections and recommendations in the ‘Code of Best Practice’. This involves relying on the company’s own account with regards to these matters. However, a combination of the companies’ legislation, accounting standards and the U.K.L.A. Listing Rules do provide some assurance about the accuracy of the information provided.

In analysing the above empirical evidence, one might deduce that institutional investors and investment managers are not particularly keen on finding out whether shareholders are provided with enough protection or not. If there is no great eagerness (in relation to the good intentions of contractual theorists) in finding out whether shareholders are provided with enough protection or not, inevitably and

\textsuperscript{135} In fact, this research shows that 87\% of institutional investors (the total market value of institutional investors that completed the questionnaire is £ 44 billion) pass the responsibility of portfolios to investment managers to invest for them, either completely or partially. Institutional investors’ questionnaire, control number 361, that had funds of an estimated value of one billion pounds at the end of the financial year 1999, claimed that: ‘100 per cent the money is all in unit trusts managed by external managers. We never get involved in investment decisions.’ This statement underlines the importance of investment managers in the L.S.E.
logically, there would be even less eagerness to negotiate better legal terms. This is
because knowing the former is a prerequisite to asking for the latter. Hence, the
contractual theory proposition of contract negotiation between investors and
corporate managers does not seem to exist on a large scale in the U.K. public listed
companies. The next section presents this chapter’s conclusions.

3.7. Conclusions

Kristol states that 'the trouble with the large corporation today is that it does not
possess a clear theoretical -i.e. ideological- legitimacy'\textsuperscript{136} within the framework of
capitalism. Kristol explicitly believes that the founding fathers of capitalism would
neither understand nor approve corporations in the form that they exist in today, i.e.,
separations between ownership and control. Referring to the founding fathers of
capitalism Kristol goes on to state:

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\text{ [...] they would have asked themselves the same questions we have been}\non\text{ asking ourselves for almost a century now: Who ’owns’ this new leviathan?}\n\text{ Who governs it -and by what right, and according to what principles?}\text{\textsuperscript{137}}\]

Clearly, corporation communitaire and concession theories may indeed struggle to
answer the questions proposed by the above quote. Contractual theory on the other
hand could, at least theoretically, provides the answers to the questions proposed by
the above quote. Contractual theory would purport that shareholders are the owners
of corporations. The corporate officers, it would explain, make major decisions,
without consulting the owners, on the basis of contract too, as shareholders freely
choose and consent to contractually authorise corporate managers with such powers.
What would logically follow is that shareholders could just as easily withdraw these
powers from corporate managers. In real life however, the essence of such concepts
begins to fall apart. Practically speaking, corporations’ managers have usurped the
control of large public listed companies. Horwitz states:

But whatever we may pretend, the corporation is in fact a social
institution as well as an economic one, and we should welcome, rather
than reject, difficulties attendant upon the recognition of that fact. To do
otherwise would be to choose one set of social consequence-those

\textsuperscript{137} ibid. at 137.
implicit in the "economic" model-without knowing what we were doing or why.\footnote{138}

Although corporation concession theory may struggle to convincingly answer the question of who owns the corporations, it is probably still the most realistic theory among the above-discussed theories, in the sense that it corresponds more with the characteristics of modern corporations, than the other corporations' theories. It is more realistic than corporation communitaire theory, since the latter theory perceives corporations as a mere tool in the hands of the state, denying investors the right to control their enterprise. It is also more realistic than aggregate theory since the latter, although it has attempted to, is not very convincing in explaining the most distinct characteristics features of the modern corporation; namely: shareholders' limited liability; separate legal entity; and, the perpetual duration of corporations.\footnote{139}

By examining the share ownership distribution in the U.K., one would realise that there was a time, particularly in the 1960s and 1970s, where there was neither private investors' share ownership concentration, nor institutional investors' share ownership concentration. The beginning up to the mid 1990s was different, in that institutional shareholders clearly dominated the L.S.E., for example. After, the mid 1990s up until the current day, institutional shareholders' ownership has evidently retreated. Due to these factors, and as mentioned earlier on in this chapter, the question addressed by some legal scholars was: do shareholders have the ability to literally apply the aggregate theory, using the so-called 'bilateral contract' to negotiate protective contract terms? Or, is it the case that large corporations have lost shareholders' bargaining powers, which once helped to explain the 'rhetoric of contract'? Investors' passivity or apathy made corporate management semi-autonomous. Investors may only want to engage themselves in earning a satisfactory profit, with less speculative, low risk investment,\footnote{140} rather than a maximum profit with high risk.\footnote{141}

\footnote{138} J. White, supra, n 47.  
\footnote{139} See, M. Horwitz, supra, n 37, at 183.  
\footnote{140} See, J. Coffee, supra, n 76.  
\footnote{141} See, E. Fox, supra, n 75.
It is quite evident that institutional investors do not greatly exploit their contractual power to negotiate better and more protective terms for themselves with corporate managers. Moreover, individual/private shareholders are even less likely to negotiate better and more protective terms for themselves with corporate managers. This is because negotiating better terms with corporate managers needs expertise and time which most individual/private investors lack. In light of this, the following two chapters examine the availability of other protections to shareholders in public listed companies, namely: through the 'unfair prejudice' remedy; and, the usage of voting and proxies, to hold corporate managers to account.
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Chapter Four

The Availability of Litigation to Shareholders as a Means to Hold Corporate Managers to Account

4.1. Introduction

The problems facing a minority shareholder seeking a derivative remedy for a breach of fiduciary duty by directors in the English system are well known. The notorious rule in *Foss v Harbottle* \(^1\) and the reluctance of the courts to ease the position of those seeking to take advantage of ‘exceptions’ to the rule was exemplified in cases such as *Prudential v Newman Industries* \(^2\) and *Smith v Croft*. \(^3\) They indicate that legal remedies are unlikely to be imminent in the thinking of institutional investors or those managing their investments on holding corporate management to account. This is still the case, despite the fact that there is a strong case for the availability of litigation to shareholders in public listed companies. The availability of litigation to shareholders in public listed companies is not only significant because of the importance of legal concepts such as authority in agency and the reality of power and authority in corporate hierarchies, \(^4\) but also because of the failure of other methods to hold corporate managers to account.

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\(^1\) [1843] 2 Hare 461


\(^4\) The debate on whether there is, or may be an international convergence of corporate governance systems and whether differences between legal systems on points of corporate law or securities law may give rise to factors relevant to the efficiency of markets has played its part in this.

One should expect that the means of litigation be available to shareholders to support the role of fiduciary duties, as a means of policing corporate managers. The availability of litigation for shareholders in public listed companies is particularly important due to the following two reasons: first, as demonstrated in chapter two, clearly the economic framework in the market does not support holding corporate managers to account due to the problem of agency cost; and second, because of the failure of contract negotiation as a means of self-help (as demonstrated in chapter three of this thesis) to provide shareholders with a meaningful method of holding corporate managers to account.\(^5\)

### 4.2. Objectives

The aim of this chapter is to outline some of the remedies that are allegedly available to shareholders in listed companies under the English legal system. Furthermore, this chapter presents some empirical insight that demonstrates some of the problems related to the use of litigation among shareholders that hold equity in the L.S.E. The questionnaires executed for this study, tested the place of litigation among a range of possible responses from dissatisfaction with company performance, to the specific attitudes of respondents on the use of litigation and their perceptions of why litigation might not be a favoured response. This included data on the place of litigation where respondents were asked to rank it as an approach to poor company performance as compared to: sale of shares; dialogue with management or non-executives; encouraging a takeover; and, coalition building. The final section of this chapter deals with those findings.

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4.3. The Protections Available to Shareholders

There are allegedly four major 'protections'/ 'remedies' available to minority shareholders. The first protection available emerged from the decision in the case of *Foss v Harbottle*. The second is to be found in s. 122 of the I.A. '1986, and the third in s. 459 of the C.A. '1985. Finally, it is possible to seek intervention by the D.T.I. or other State authorities. In the context of shareholders in a public listed company, the remedies of 'just and equitable' winding up and the usual order for a buy out of the aggrieved minority under s. 459 of the C.A. '1985 are of little relevance. Yet it is necessary to the context of this thesis to outline these remedies.

In discussing these protections, it is important to mention the 'proper plaintiff principle'. This principle emphasises that the company is an independent legal person, to which duties are owed and which will sue and to be sued separately from its shareholder. The proper plaintiff principle represents the first part of the decision made in the case of *Foss v Harbottle*. The second part of the decision illustrates that if a simple majority could ratify the conduct of management, then no other member can sue on the basis of that conduct. Nevertheless, in companies other than public listed companies, this may give rise to the problem of injustice and effective loss of property rights, if the majority of shareholders are in control of the board of directors and they collude on breaches of the directors’ legal duties in a way which deprives the minority of their property. The same applies to shareholders in public listed companies. Yet, since shares are normally too widely dispersed for any particular group to control the company, the problem of controlling a conflict of interests, shifts from majority shareholders versus minority shareholders, to shareholders versus management.

The company can only act through human agents (i.e. the board of directors and executives or employees). These agents, in most cases, are probably the controllers of the company in the sense that the board has the power to decide

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6 [1843] 2 Hare 461.
7 ibid.
whether the company should sue wrongdoers (Article 70 of Table A) and possibly because they control a majority of the votes in the G.M. Hence, they will not pursue an action against any improper act that they have themselves committed. In such situations, the non-controlling party has no remedy for the wrongs committed by the controllers and therefore, they are at the mercy of the aggressors. Justice required something to be done, which resulted in the courts' development of the four exceptions to the rule in *Foss v Harbottle*. The first exception is when the conduct is illegal or *ultra vires*. Individual shareholders, here, could bring action to prevent the illegality or *ultra*, but could not claim damages after the event.

The second exception is when the conduct requires special procedures in order to be approved. Here, a simple majority, which can be formed by those in control, is not enough, and the votes of the minority must be considered; holding more value. Such a procedure will usually be outlined in the articles of the company and any attempt to escape it, by passing an ordinary resolution instead of a special one, will be restrained. This might, for example, arise because the law requires that a special resolution, rather than an ordinary resolution, such as in the case of changing the company's memorandum and/or articles of association (s. 4 and s. 9 C.A. '1985). This is also a right of the individual shareholder to have the 'majority' rule respected.

The Third exception to the rule in *Foss v Harbottle* is when the conduct under complaint, infringes a personal right. Such a breach is one of a personal right, harming shareholders, (particularly minority shareholders), in a personal capacity and hence, shareholders can bring a personal action and

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8 *Burland v Earle* [1902] AC 83, mentions what could be done.

9 *Edwards v Halliwell* [1950] 2 All ER 1064, summarises the exceptions in 1066.

10 Now available in s. 35 (2) C.A. '1985.

11 Approved by Knox J in *Smith v Croft* [1987] 3 All ER 909.

12 *Quin and Axtens Ltd v Salmon* (1909) AC 442.

not a derivative one. However, a member’s rights are limited. A member does not have the right to have all the articles observed. Some of those more limited rights are present in shareholder contracts, statutes and the articles of the company. Classic examples of such rights include the case of *Pender v Lushington*¹⁴ — voting is a personal right, and *Wood v Odessa Water Works*¹⁵ — dividend in the form of cash as a personal right. By way of contrast, *McDougall v Gardiner*¹⁶ indicated that the procedural right to insist on a poll, rather than a show of hands at a meeting, is a procedural right of the company and not a right of the individual shareholder. The leading modern case defining the scope of these rights is the case of *Cumbrian Newspaper*¹⁷. A more liberal view shows that a personal right might also arise where there is a breach of a director’s duty, which gives rise to take personal action.¹⁸

The fourth exception to the rule in *Foss v Harbottle* is when the conduct of the controllers of a company, results in an act of fraud against the controlled shareholders. This is a true exception. While previous examples involve some form of individual right, rather than a reaction to a wrong against the company, this exception allows a derivative action, whereby the minority shareholder sues using the company’s name. It is a useful exception because the courts tend to interpret the word ‘fraud’ on a very wide basis. The interpretation could include: appropriation of corporate property¹⁹; self-seeking²⁰; and, abuse of power,²¹ i.e., where the directors act *mala fide*, not in the interests of the company, or for a collateral purpose. Nonetheless, an action of fraud against the minority will not be permitted unless the claimant

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¹⁴ (1877) 6 Ch D 70.
¹⁵ [1889] 42 ChD 636.
¹⁶ [1875] LR 10 Ch App 606.
¹⁸ *Re a Company* (No 005136 of 1986) [1987] BCLC 82. Though, it must be noted that this was only related to a breach of the company constitution.
¹⁹ *Cook v Deeks* [1916] 1 AC 554.
²⁰ *Daniels v Daniels* [1978] Ch 406.
²¹ *Bamford v Bamford* [1969] 1 All ER 969.
can establish that those who have performed the wrong conduct, are actually controlling the company, and hence, forbidding it from raising an action in its own capacity. Furthermore, it should be noted that the procedural problem of having two hearings\(^2^2\), which was explicitly upheld by the Court of Appeal in *Prudential Assurance Co Ltd v Newman Industries Ltd (No. 2)*\(^2^3\), provides a further obstacle to the use of the exceptions to the rule by minority shareholders.

Generally, the exceptions to the rule in *Foss v Harbottle* are harsh and uneasy to use, and moreover, a shareholder might not be able to pay the expenses of a costly action under the common law. Apart from these factors, it might be extremely difficult to establish wrongdoing and fraud against shareholders, if the shareholders have very limited access to company information. Therefore, alternative remedies were required.

A more suitable remedy may be the winding up order on the 'just and equitable' ground.\(^2^4\) Even so, the order is limited to situations where the petitioner can prove an interest in the winding up order, i.e., a shareholder must prove that he/ she will benefit from the surplus of the company’s assets after the winding up (i.e. that the company is solvent).\(^2^5\) This gives wide discretion to the court in deciding on which case a petitioner can obtain such an order. Circumstances where the courts tend to uphold such an action are in cases where there has been a deadlock in the relations between shareholders, which usually only arises in small private quasi partnership companies.\(^2^6\)

\(^{22}\) One hearing to decide whether fraud has been committed on the minority, and the other hearing to decide the substantive issues.

\(^{23}\) [1982] Ch 204.

\(^{24}\) Section 122 (1) of the Insolvency Act 1986: 'a company may be wound up by the court if (g): the court is of the opinion that it is just and equitable that the company should be wound up'.

\(^{25}\) *Re Gold Washing Ltd* [1879] Ch.D 36, states that the complainer needs to prove advantage or minimising disadvantage.

\(^{26}\) *Re Yenidje Tobacco Co Ltd* [1916] 2 Ch.426.
Another situation where such an order could be upheld, is when there is a loss of substratum, i.e., when the purpose for which the company was established has been achieved or has failed. A further situation is when there is a loss of confidence in the management of small quasi partnership types of company. The final and most important situation, where the court will grant a winding up order, is where there has been a breach of a legitimate expectation. The leading opinion is that of LJ Wilberforce’s in the case of *Ebrahimi v Westbourne Galleries.*\(^2\) This decision was a leading one on cases that concerned quasi partnership types of companies. LJ Wilberforce indicated that for a court to grant a winding up order, the company must be a formed association, based on a personal relationship involving mutual confidence.\(^2\) Further requirements to uphold such an order are; firstly, there must be an agreement or understanding that some or all members will take part in the running of the company, and secondly, that a restriction exists on the transfer of a member’s interest in the company.

In conclusion, the ‘just and equitable ground’ definitely strengthened the position of minority shareholders in private companies, especially in the case of small private quasi partnership type companies. It looked beyond the actual rights of a shareholder, into his/her legitimate expectation.\(^2\) The remedy is indeed suitable for those minority shareholders, in companies which were established on a certain basis with the intent of continuing to do so, but later tend to change. It is noticeable that the decision in the *Ebrahimi* case helped clarify the requirements for a winding up order. Also, the decision in the *Ebrahimi* case aided in interpreting the major concept of ‘legitimate expectation’, in the remedy presented in s. 459 CA '1985.\(^3\)
However, the ‘just and equitable ground’ remedy, which is meant to protect shareholders in quasi partnership types of company, is extremely unlikely to have any application as a remedy to shareholders in public listed companies. This is because the companies do not fulfil the first requirement established by LJ Wilberforce.31

A further remedy that can be pursued by shareholders is a request for an investigation by the D.T.I. The investigation can be pursued in three ways. The first is by a court order, the second is by a request of the company itself, and the third is when there has been fraud, unfair prejudice or withholding of information. Under this remedy, the D.T.I. is usually reluctant in using its power, because the appointment of an investigator can cause long term damage to the company. However, one must note that the D.T.I. could in certain circumstances carry out confidential investigations.

The distinction between inspections that may be publicly announced and can lead to published reports (as those normally conducted under s. 432 of the C.A. '1985), and confidential, unpublicised investigations (as under s. 447 of the C.A. '1985), is as follows. The former is undertaken in cases of suspicion of unlawful, dishonest or improper conduct that is a matter of substantial public concern. The latter is however, undertaken where there is good reason to do so, on the basis of information received, to establish if there is any cause for concern or for further action. As far as investigations by the D.T.I. are concerned, there is no evidence to suggest that they are widely used.32 It seems that traditionally, the D.T.I. was understaffed to make any effective use of such a useful remedy. Yet, the D.T.I. recently carried out an

31 The requirement that the company was formed based on a personal relationship is unlikely in public companies. However, also look at Sir Donald Nichol’s comments on ‘special types of public company’ in Re Tottenham Hotspur PLC [1994] 1 BCLC 655.

32 Yet, one must say that according to the D.T.I. (Company Investigation: Powers for the 21St Century)’ the company investigations have a valuable continuing function in upholding standards of conduct of limited liability to companies and in helping to counter crime and other wrongdoing, thereby helping to make the U.K. an excellent place to do business.
investigation titled ‘Company Investigation: Powers for the 21st Century’ proposing for modernisation and simplification and strengthening the legal powers to ensure the future effectiveness of investigations. The D.T.I. aims to achieve a modernisation of the powers available, as part of the legislation to implement the Government’s response to the Company Law Review. Such a move is to be welcomed, yet it remains to be seen whether or not the D.T.I. can achieve this.

In summary, the remedies available to minority shareholder are in no doubt varied. However, so far, other than the potential use of D.T.I. investigations of companies, there has been little application, if any, of the exceptions to Foss v Harbottle and the ‘just and equitable ground’ remedy, in the context of public listed companies. Derivative action is difficult to prove and establish, and a simple majority in certain situations can ratify the wrongful conduct. It is also expensive. Minority shareholders in small companies might find it cheaper to accept directors’ or majority shareholders’ unfairness, rather than pay for a derivative law suit. Personal action is of little use, if the shareholder cannot distinguish between what is considered his / her personal right and what is not. Section 122 of the I.A. ’1986 on the other hand, is limited in only making the remedy available to small quasi partnership type companies. Moreover, such a remedy was thought as ‘tantamount to killing the goose that might lay the golden egg’. Therefore, provisions that were more specific were necessary for the court to grant a wider range of remedies against the oppressive misconduct of directors.

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34 Not where a special resolution is required.
35 P. Davies, Gower and Davies Principles of Modern Company Law, (Sweet & Maxwell, London, 2003), chapter 24, at 662. ‘In many cases the winding up of the company will not benefit the minority shareholder, since the break up value of the assets may be small, or the only available purchase may be that very majority whose oppression has driven the minority to seek redress’, extracted from the Cohen’s report; Cohen (Committee Chairman), Report of the Committee on Company Law Amendment, Cmnd 6659 (1945), para 60.
chance of relief for minority shareholders may stem from s. 459 of the C.A. '1985.

4.4. The Unfair Prejudice Remedy
First, and before commencing the discussion on the 'unfair prejudice remedy', it is important to follow its historical development and how its application was diverted away from public listed companies. Historically, in the U.K., the provisions to allow company shareholders to petition the courts, to remedy an oppressive conduct by company controllers, came as a response to the Cohen Committee recommendations. The Committee recommended that the courts should impose whatever settlement it considered to be 'just and equitable' to shareholders [paragraph 60]. The provision first appeared in s. 210 of the Companies Act 1948.

The Cohen Committee recommended a new provision to be enacted 'to strengthen the minority shareholders of a private company in resisting oppression by the majority'. Such a recommendation is extremely significant, since it might have formed the foundations of preventing shareholders in public listed companies from using such a remedy. Interestingly enough, however, s. 210 of the Companies Act 1948, which directly responded to this recommendation, did not expressly restrain shareholders in public listed companies from using the unfair prejudice remedy. Nevertheless, practically speaking, the fact that s. 210 of the Companies Act 1948 restricted the application of such a remedy to the satisfaction of the courts, *inter alia*, on achieving 'just and equitable' grounds for a winding-up order, made the application of such a provision limited to private companies, and hence, excluded members of public listed companies.

36 Cohen, supra, n 35.
37 The wording of s. 210 of the Companies Act 1948 rendered the essence of the Cohen Committee's recommendations (i.e. 'just and equitable') unrealised. The Parliament interpreted 'just and equitable' rather strictly, resulting in its application to oppressive conduct only.

The Parliament's interpretation of the Cohen Committee's recommendations also limited the operation of s. 210 in many ways. Firstly, s.210 of the
There are no reported cases that involve public listed companies in the U.K. to demonstrate how the courts would have interpreted s. 210 of the Companies Act 1948. However, in Australia and relying on s. 186 of the ‘uniform’ Companies Act of the Australian States 1961, similar to s. 210 in the U.K., the Court disallowed relief under ‘just and equitable’ grounds, in the case of *Re Weedmans Ltd*[^38] for the mere fact that the company was a listed company[^39].

In fact, in its long history, there have only been two successful actions under s. 210 of the Companies Act 1948, namely: *Scottish Co-operative Wholesale Society Ltd v Meyer*[^40] and *Re H.R Harmer Ltd*,[^41] which can be partially ascribed to the unclear recommendations of the Cohen Committee and to the strict interpretations of the recommendations by the D.T.I. and parliament. Further consideration was necessary, which resulted in the Jenkins

[^39]: In Australia, there are another two reported cases with the same outcome of relief being disallowed, based on the fact that the companies were listed. These two cases are namely: *Cumberland Holdings Ltd v Washington H Soul Pattinson & Co Ltd* [1977] 3 ALR 561 (PC), and *Re Kornblums Furnishings Ltd* [1981] 6 ACLR 456.
[^40]: [1959] AC 324.
[^41]: [1959] 1 WLR 62.
Committee. The Jenkins Committee brought in new proposals to fill the gaps and inconsistencies in s. 210 of the Companies Act 1948.

The main recommendation of the Jenkins Committee in relation to s. 210 of the Companies Act 1948, was to abolish the ‘winding-up requirement’. Furthermore, the Jenkins Committee recommended, inter alia, the replacement of the concept of ‘oppression’ with that of ‘unfair prejudice’. Hence, s. 210 of the Companies Act 1948 was replaced with s. 75 of the Companies Act 1980.

A petition under the new section no longer requires a precondition that a winding up order must be applicable or available. The word ‘oppression’ has changed to a less restrictive phrase, ‘unfairly prejudicial’. In addition, the petition does not require continuous misconduct as s. 210 did. Now, an independent action is sufficient, as is a proposed act or omission. Section 75 of the Companies Act 1980, afterwards became s. 459 of the C.A. '1985. A further development in s. 459 that was not a result of the change expected from the wording in s. 210 of the Companies Act 1948, was the wide judicial interpretation of an unfairly prejudicial conduct, to cover membership interest and not membership rights only.

The Jenkins Committee did not elaborate on the position of members of public listed companies and whether they would have been able to use such a remedy, and moreover, its report does not give any indication to whether or not the Committee meant to include members of listed companies. However, there have been reported cases to help clarify the status of shareholders in public listed companies, concerning their ability to use such a remedy once

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42 Jenkins (Chairman), Report of the Law Committee, Cmnd 1749 (1962), para 212(a).

43 The committee wanted change to be implemented, for at the time, shareholders were unfairly prejudiced because: a. (directors were appointing themselves in high remuneration posts; b.) directors refused to register the personal representatives of shareholders; c.) the issue of shares to directors and others on advantageous terms; and, d.) failure of directors to declare dividends. See, D. Keenan, Smith and Keenan’s Company Law for Students, (Pearson Higher Education, London, 1993), chapter four, at 276.
'unfair prejudice' has been conducted by the controllers of public listed companies.\(^4^4\)

Even though bringing action under 'unfair prejudice' in all reported cases that involve public listed companies were unsuccessful, it was only in the case of *Blue Arrow PLC*\(^4^5\) that the court bluntly related the reason for striking out the petition to the fact that the company was publicly listed. Vinelott J was critical of such deals that would give legitimacy to 'side deals' between shareholders about the management of listed companies, not disclosed in public documents. This is because acknowledging such side deals would have serious implications on the way listed companies are traded upon.

Conspicuously, Vinelott J stated that investors in a listed company are entitled to assume that the whole of its constitution is contained in the articles of association, together with the Companies Acts. There was no room for any legitimate expectation, founded on an agreement between directors and the general public. This is because any such agreement should be published and fed back to the market. Furthermore, it is unusual for the articles of association of a listed company to provide certain shareholder(s) with rights that raise the issue of legitimate expectations, such as the right to appoint board members. There is, however, a precedent for the rights attached to the government's 'golden shares', in a number of privatised companies. Hence, in the case of listed companies, courts are unlikely to entertain unfair prejudice actions, based on expectations derived from side deals between shareholders, not disclosed to all shareholders.

Some of the possibilities of, for example, using s. 459 of the C.A. '1985 to insist on meetings being called on the requisition of a minority of shareholders, complement some of the results from this study's


questionnaires (see Scottish cases of *McGuinness v Bremner*46). More generally, the argument that this remedy like the others, is of limited use within the context of public listed companies, helps to explain the focus on the role of institutional shareholders and investment managers in holding management to account. In relation to this, the next subsection outlines the limited scope of the unfair prejudice remedy, in its application only to quasi-partnership companies, with limited relevance to public listed companies.

### 4.4.1. Early Problems with Section 459 of the Companies Act 1985

Two immediate issues arose from s. 459 of the C.A. '1985. The first concerned bringing an 'action *qua* member' and the second was the interpretation of the words ‘some parts’ of the members of the company. As for the issue of ‘action *qua* member’, it had been debated in judicial interpretations under s. 210 of the Companies Act 1948. The action was confined to a person in the capacity as a member and not in any other capacity. Hence, it protected a member’s rights. However, after the introduction of s. 75 of the Companies Act 1980 and s. 459 of the C.A. '1985, judicial interpretation quickly came to the conclusion that a petition under those sections can be brought if the conduct complained about is prejudicial to the member’s interests as well as the member’s rights Courts showed that they were willing to give wider consideration to equitable grounds as in the *Ebrahimi* case.

The basis of this wide consideration comes from the opinion of Hoffmann J in many cases.47 For example in *Re a company [No. 008699 of 1986]*,48 Hoffmann J expressly indicated that the word ‘interest’ is wider than the word ‘rights’, and since s. 459 of the C.A. '1985 uses the word ‘unfair’, it does include a member’s interests. Hence it is not doubted that ‘unfair prejudice’ does include a member’s rights and interests, whether they derive

46 [1988] SLT 891

47 *Re Cumana Ltd* [1986] BCLC 430; ‘Conduct unfairly prejudicial to the interests of a member’.

48 2 BCC 99,024 at 99,029.
from the company’s articles, memorandum, shareholders’ agreement or some
general equitable duty, owed by the directors or the shareholders to the
company or another shareholder.\(^{49}\) Hoffman J in *Re Postage and Denby
(Agencies) Ltd*\(^{50}\) indicates that it is a matter of jurisdiction to look at the
member’s rights and legitimate expectations, i.e. their interests that arise
from some form of understanding with the directors or the majority. The next
question, therefore is, where do the boarders lie in relation to a member’s
interests? The best clarification could be that given by Griffin, who states:\(^{51}\)

A member’s interest in a corporate concern can be described as an
expectation which is linked to the proper functioning of a business
organisation in which the shareholder has or had a financial stake.

It is clear from the above quotation, that a member’s interest does not include
the member’s personal affairs, which are out of scope with the company’s
actions.\(^{52}\) It must be a corporate interest and not a personal interest that has
been prejudiced. The courts try to identify the interests of members by
looking beyond the legal entity of the company to the individuals within it
and having regard for their rights, expectations and obligations *inter se*.\(^{53}\)
However, the extent to which a member’s interests expand remains unclear.

It may be heartening to see courts interpret s. 459 of the C.A. ’1985 in favour
of the minority or the unfairly prejudiced member. However, could they be
going too far? What if the act sued against is in the interest of the company,
and hence in the interest of all members? Could that not be a justification to
the prejudicial act? These are all questions unanswered. The C.A. ’1985, in
general, and s. 459 of the C.A. ’1985 in particular do not clarify the situation.
However, it would be more suitable, in relation to an unfairly prejudicial

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49 R. Hollington, *Minority Shareholder’s Rights*, (Sweet and Maxwell, London,
1999), chapter 4, para.37.


51 S. Griffin, supra, n 37.

52 An example is building on land next to a member’s land.

1998), chapter 27, at 463; deduced his quotation from *Ebrahimi v
Westbourne, Galleries and Re Postgate Denby Ltd.*
conduct, for the reasonable bystandard test,\textsuperscript{54} to consider any conduct performed for benefiting all members in the long term. The courts, however, would be reluctant to interfere in a complained conduct that was merely an exercise of business judgement.\textsuperscript{55} However, more clarification is required from s. 459 of the C.A. '1985, to indicate which interests are to be considered. It would be much more preferable for the act to adopt a more sensible approach in considering a company’s interests, prior to that of its members, because it is the company that will be primarily affected by the conduct.\textsuperscript{56}

As for s. 459 of the C.A. '1985, usage of the term ‘some part’ of the members of the company, indicated a need for discrimination against the petitioner. Unfair prejudicial conduct, which affects all members equally, is insufficient to uphold a case based on s. 459 of the C.A. '1985. Yet, the judicial interpretation of the word ‘part’ has varied. Vinelott J in \textit{Re Carrington Viyella PLC},\textsuperscript{57} made it clear that there would be no relief under the unfair prejudice remedy, if the conduct affected all members equally. A further dictum is that of Harman J.\textsuperscript{58}

In turn, he initially followed Vinelotte J’s dictum in relation to a need for discrimination against a part of the members. However, Harman J did distinguish between two situations. The first is where the board intended and was able to discriminate in its conduct, even though it appeared to apply to

\textsuperscript{54} It is the objective test of an unfairly prejudicial conduct, which is discussed later in this chapter.

\textsuperscript{55} \textit{Elgindata Ltd, RE} [1991] BCLC 959, at 993: ‘...the court will be very reluctant to accept that managerial decisions can amount to an unfairly prejudicial conduct.’ Many authors do not propose this, however the author of this thesis sees a very strong relation between such a test and the ‘proper purpose’ test of directors’ duties. \textit{Howard Smith Ltd v Ampol Petroleum Ltd} [1974] AC 821.

\textsuperscript{56} \textit{O’Neill v Phillips} [1999] 1 WLR 1092.

\textsuperscript{57} [1983] 1 BCC 98,951.

\textsuperscript{58} \textit{Re a Company} (No.00370 of 1987) [1988] 1 WLR 1068.
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all members equally. The second situation, is where the conduct even though unfairly prejudicial, applied to all members equally. In the former instance, a petition under s. 459 of the C.A. '1985 would be successful. The conduct in such a situation, even though applying to the whole, was intended to discriminate between parts of the membership, and so the discriminatory requirement of s. 459 of the C.A. '1985 was satisfied. In the latter situation, a petition would fail because the conduct complained of would be to the detriment of the whole body of members, without any element of discrimination.

On the other hand, Gibson J in Re Sam Weller refused the courts’ interpretations of an unfairly prejudicial conduct. He indicated that an action by a part of the members should not be dismissed on the ground that the prejudicial conduct affected all members equally. There is no doubt that Gibson J’s view has prevailed. It is now clearly indicated in s. 459 as amended by the C.A. '1985, schedule 19 paragraph 11, that an action would be available when the prejudicial conduct affects the interests of members as a whole.

Section 459 of the C.A. '1985, as amended 1989, provides that:

A member of a company may apply to the court by petition for an order under this part on the ground that the company’s affairs are being or have been conducted in a manner which is unfairly prejudicial to the interests of its members generally or of some part of its members or


60 Re a Company (No.00370 of 1987) [1988] 1 WLR 1068.

61 In Re a Company [1985] BCLC 80, the board’s intention was to weaken the petitioner since it knew the petitioner’s inability to take up the share issue. Harman J latter adjusted his view to include situations where the conduct, even though applying to the whole, discriminated against a part where there was no intention of discrimination on the part of the company. (Re Company (00789 of 1985) [1989] 5 BCC 792).

62 Re a Company (No.00370 of 1987) [1988] 1 WLR 1068 at 1074 to 1075. ‘I am of the opinion that no s. 459 petition could be based on conduct that has had an equal effect on all the shareholders and was not intended to be discriminatory between shareholders.’ (Harman J).

that any actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial.

Some shareholders might be deceived into believing that s. 459 of the C.A. '1985 is an ultimate source of protection. In fact, s. 459 of the C.A. '1985 is obscure in many ways. The main obscurity is in the term 'unfairly prejudicial. The term is not defined within the section, nor is it defined in any other part of the Companies Act. In addition, judicial interpretation has offered little help in providing a clear interpretation of the term 'unfairly prejudicial'. It seems that the courts have refused to limit themselves to certain boundaries of what constitutes unfairly prejudicial conduct, perhaps because they wish to allow themselves wide discretion. The only thing deduced from the case law is that: 'the [relevant] conduct must not only be prejudicial to the interest of the member but also that it should be unfairly so.'

However, some may argue that the HoL judgments in *O'Neill v Phillips* indicate a narrowing of the range of circumstances to be regarded as amounting to 'unfair prejudice'.

Conduct may be prejudicial where the value of the petitioners' shares have been diminished or seriously jeopardised, or where there have been unreasonable delays in convening meetings, or where there has been exclusion from management in a quasi-partnership type of company. However, the prejudicial conduct must be unfair. Some forms of unfairness are: when the defendants' actions are unscrupulous, lack probity, are harsh, burdensome or wrongful towards any member of the company; when the conduct was a visible departure from the standards of fair dealing or a

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64 Peter Gibson J in *Re Ring Tower Holdings PLC* [1989] 5 BCC 82.
65 [1999] 1 WLR 1092
68 *Re Cumana Ltd* [1986] BCLC 430.
69 Buckley J in *Re Five Minute Car Wash Service Ltd* [1966] 1 WLR 745.
violation of the conditions of fair play;\textsuperscript{70} or, when non payment of dividends exists.\textsuperscript{71} Most writers tend to accept the view that both terms, unfair and prejudicial, together must express: ‘a form of detriment which would strike a man of business as unjust or inequitable.’\textsuperscript{72}

It is clear that there is no intention on the part of Parliament, the courts or even writers, to give an exact definition of unfairly prejudicial conduct. However, this is probably beneficial; firstly, because the complaints of the petitioner could be for infinitely various reasons and it would be illogical to codify them within a section of an act, and secondly, the world changes, leading to unknown situations, which a strict definition of the term unfair prejudice would probably fail to cover. This can be clearly observed from the way courts have tended to tackle situations where the petitioner is no more a member.\textsuperscript{73} Parliament most likely intended to give the courts broad discretion in deciding when there has been unfair prejudice, as narrowness was one of the problems with the old s. 210 of the Companies Act 1980.

It is quite clear in most cases, that the test of unfair prejudice is an objective one.\textsuperscript{74} It is the test of a reasonable bystander, and whether or not such a bystander regards the conduct as unfairly prejudicial. Therefore, the courts are more concerned with the effect of the conduct rather than its nature. In relation to this, Prentice once said: ‘[t]he focal point of the courts enquiry in determining whether conduct has been unfairly prejudicial is its impact and

\begin{itemize}
\item \textsuperscript{70} LJ Cooper in \textit{Elder v Elder and Watson Ltd} [1952] 5 SC 49 at 55 also adopted by the Jenkins Committee.
\item \textsuperscript{71} Gibson J, \textit{Re Sam Weller and Sons Ltd} [1989] 5 BCC 810.
\item \textsuperscript{72} Instone, supra, n 37, 20, at 21; and, L. Griggs and J. Lowry, ‘Minority Shareholder Remedies: A Comparative View’, (1994), \textit{Journal of Business Law}, 463, at 466.
\item \textsuperscript{74} G. Stapledon, ‘Mismanagement and the unfair prejudice provision’ Company Lawyer, (1993) 14 (5) 94 at 94-95, where he cited Warner J when saying: ‘[t]he test of unfairness must be an objective not a subjective one. The test is whether a reasonable by standard observing the consequences of their conduct would regard it as having unfairly prejudiced the petitioner’s interest’.
\end{itemize}
not its nature.\textsuperscript{75} The objective test could be asserted in the case of \textit{Re Sam Weller}, where Gibson J stated that the conduct, which is unfairly prejudicial to the petitioner's interests, even if not intended to be, might nevertheless come within the s. 459 of the C.A '1985.\textsuperscript{76}

An application of the test could be seen in \textit{Re RA Noble and Sons (Clothing) Ltd.}\textsuperscript{77} Using the objective test, it was held that the conduct of the directors in excluding the petitioner from management had been prejudicial but not unfairly so, because the petitioner brought it upon himself by lack of interest in running the company. The certainty of the objective test of unfair prejudice is no longer doubted and all recent cases\textsuperscript{78} establish that, whether or not a conduct is fairly prejudicial is to be determined objectively. Therefore, there is no requirement to show bad faith on the part of the directors of a company.\textsuperscript{79}

For a petition under s. 459 of the C.A '1985 to succeed, the petitioner must fall within the ambit of a member who has the right to sue for an unfair prejudice remedy. Section 460 of the C.A. '1985 also gives the right to raise an action to the Secretary of State. However, such a power has never as yet been used. It is usually s. 459, rather than s. 460, which is relied upon. The definition of a member is presented in s. 22 of the C.A. '1985. It states that a member must be a subscriber to the memorandum of association, or entered as a member in the company's register of members.

Section 459 of the C.A. '1985 also extends the definition of a member to a person to whom shares have been transferred by a proper instrument of transfer. However, the transfer must be by operation of law. Harman J

\begin{footnotes}
\item[75] [1988] 8 OJLS 55, at 78.
\item[76] [1989] 5 BCC 810
\item[77] [1983] BCLC 273.
\item[78] An example is \textit{Little Olympian Each-Ways Ltd (No.3)} [1995] 1 BCLC 636.
\end{footnotes}
defined 'operation of law' in *Re A Company (No 007828)*\(^{80}\) as: 'some act in the law by which the legal estate passes even though there be some further act to be done.' Hence, an agreement by itself is insufficient; there must be an instrument of transfer\(^{81}\).

A very common situation where the question of *locus standi* arises is when the shares of a director are held by his/her spouse as a nominee. The question here is whether the nominee can sue under s. 459. Although, no case has answered the question directly, it is doubted that the courts would take another view than that of Hoffman J's in *Re A Company (No.003160 of 1986)*\(^{82}\). Hoffman J declared that if the shares were to be held by the director and not his/her spouse, then the director would in no doubt be able to use s. 459 of the C.A. '1985. He also conceived no reason why this should not be the situation when the shares are in the nominees name.

No petition will be successful, if the conduct complained of is between shareholders. The act or the proposed act must be an act performed on behalf of the company and that this proposed company’s act should be unfairly prejudicial. The major requirement for a petitioner to have *locus standi* under s. 459 is that the conduct complained of must be one performed by the company. This is quite evident in Harman J’s opinion in *Unisoft Group Ltd*, stating that:

> In my judgement the vital distinction between acts or conduct of the company and the acts or conduct of the shareholder in his private capacity must be kept clear. The first type of act will

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81 Hoffman J in *Re A Company (No.003160 of 1986)* [1986] 2 BCC 99, 276: 'In my judgement the word transferred in s. 459 (2) requires at least that a proper instrument of transfer should have been executed and delivered to the transferee or the company in respect of the shares in question. It is not sufficient to have an agreement of transfer'. Mentioned in R. Hollington, supra, n 49.
82 'I do not see why, if such, was the understanding between the parties, it should not also include an expectation that a nominee member’s husband and beneficiary should enjoy such rights and benefits.'
found a petition under unfair prejudice provision; the second type of act will not[^1].

The quotation above is not new. It was also established by Harman J in earlier cases. For example, in *Re A Company (No. 00176)*[^2], he concluded, ‘the conduct complained of must be in the affairs of the very company in respect of which the petition is presented.’ Hence, the question of *locus standi* is still wide open for further judicial decisions.

After demonstrating that the law has failed to provide serious remedies to shareholders in listed companies, it is important to provide some empirical insight to whether institutional investors and investment managers would take the route of litigation, if dissatisfied with corporate managers. The Institutional investors and investment managers who participated in this study were asked to rank the remedy of using litigation against other possible remedies provided, namely: sell shares; discuss with management; discuss with non-executive directors; try to encourage take-over of the company; and form a coalition with other shareholders to take action.

These results were obtained from a question providing seven possibilities (six plus ‘other’) in which respondents were asked to rank in order of preference. The ‘mean’ is thus a ‘score’ out of seven. The results were similar among both groups and matched the expectation of low tendency among both groups towards using litigation. As demonstrated by Tables 4.1 and 4.2 (Appendix G) the most popular option was selling shares, while litigation was a very unpopular choice among both groups. However, the questions on choice of remedies only related to company performance and did not test the response where litigation or the involvement of lawyers was seen as being available. It is, after all, unlikely that these respondents would see legal remedies as an action to be taken against poor company performance, other than cases of gross negligence or outright fraud by management. Poor performance is a

risk that shareholders take and one from which they would probably not expect the legal system to protect them.

The author therefore, included a question specifically geared to cases in which respondents believed litigation or the use of lawyers to be ‘available’ in respect of their dissatisfaction with management. As in Table 4.3 Table 4.4 (Appendix G) these results show a strong propensity on the part of both groups to resist litigation, even where resorting to lawyers was seen as being ‘available’.

The resistance to court action is perhaps understandable, but the question refers to simply ‘involving lawyers’ or, in the case of investment managers, advising the client to do so. However, even this level of resorting to the legal system was unpopular with the respondents. It is also worth noting that the question was limited to situations in which ‘litigation is available’. This makes the resistance to the use of the law even more marked. It is noticeable that the investment manager respondents had a much smaller level of uncertainty than the institutional investor respondents, such as pension funds and insurance companies. This feature was present in the responses to many of the questions, but here it could arguably point to uncertainty about when litigation would ‘be available’. If one took the view that respondents would regard this as more likely in cases of fraud or dishonesty, than in cases of negligence, the results are even more striking.

In the light of this finding, it was interesting to explore the reasons for this negative attitude towards the use of the legal system. The questionnaires offered those respondents in each group who had indicated that they would not use litigation or involve lawyers even if litigation is available, six possible reasons namely; high cost of legal action, risk of management retaliation, effect on share price, time consumption nature of process, bad publicity, and, the lack of clarity of in the laws.
Table 4.5 (Appendix G) demonstrates that as far as investment managers are concerned, the high cost of legal action and time consumption are the strongest reasons against using litigation or involving lawyers, even if litigation is available. Specifically, 64.3% of investment managers thought that the high cost of the legal action is a deterrent of using litigation or involving lawyers, even if litigation is available. Similarly, 57.1% of investment managers thought that the time consuming nature of the legal process is the reason for not using it. As for the institutional investors group none of the provided reasons have reached the threshold of 50% as a deterrent of using litigation or involving lawyers, even if litigation is available. Institutional investors actually agreed with investment managers in that the most popular deterrents for using litigation or involving lawyers, even if litigation is available are the high cost and time consumption of the process. Yet, only 35.3% of institutional investors and 29.4% of institutional investors thought that the high cost and time consuming nature of the process were deterrents against using litigation or involving lawyers, even if litigation is available.

Interesting conclusions can be drawn from these results. They tend to confirm one's intuitive view that the cost of litigation in terms of time and money is a key factor. This was by far the most important consideration for both groups. This perhaps confirms the widely argued view that litigation is taken as a last resort, given the relatively small stake of any particular institution in any company and the small return to any particular shareholder from a derivative action. This attitude is reinforced by the ease with which alternative remedies can be used and their evident popularity. They include: communication with management or non-executives and are supported by the developed U.K. culture, exemplified by the Combined Code of Practice on Corporate Governance; the role of non-executive directors; the disclosure requirements of the Listing Rules; the thriving financial press and analyst communities; and, the need for companies to come to the markets for fresh capital.
They do not depend solely on the possibility of exit, which may not exist for large institutional shareholders who need to maintain a balance of holdings across the F.T.S.E. top 100. However, according to the results of this study, the sale of shares remains the favoured option with both institutional shareholders and investment managers. In this context, it is interesting that both the likely effect of litigation on share price and its propensity to cause bad publicity seemed to be more important to investment managers than to those operating within the institutions. Perhaps this reflects the closeness of fund managers to the market and a more direct link between the performance of investments and their own rewards or business success.

The fact that vagueness in the legal rules was almost the least important factor for both groups casts doubt, in the context of listed companies, on the importance that recent reports from both the Law Commission and the Company Law Review Report place on codifying directors’ duties. The fear of management retaliation was the least important factor for both groups of respondents. This may reflect the perceived power balance between investors and their managers on the one hand, and corporate management on the other.

However, while there is little evidence here of any revival of faith in the influence of the legal system and its rules in this context, it is important to note that that the attitudes of all the actors in this field have probably been conditioned by operating in the shadow of the law as it stands in the U.K. The traditional reluctance of the U.K. courts to intervene in the internal affairs of a listed company at the request of a minority shareholder, given the disparity between the cost of court action and the likely damages to be recovered\(^5\), may have influenced the attitude of the study’s respondents.

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85 Prudential Assurance Co Ltd v Newman Industries Ltd (No 2) [1982] Ch 204, at 224, where an invitation to give judicial approval to the public spirit of an active institutional investor in pursuing litigation was forcefully rejected.
4.5. Conclusions

In summary, this chapter has showed that other than the potential application of the D.T.I. investigation as a means to hold corporate managers to account, the other alleged remedies virtually do not exist as far as shareholders in public listed companies are concerned. Shareholders in other types of companies are not enjoying a much better position, however. Simply, the law governing minority shareholders in the U.K. is old and weak. Even the latest amendments (1989) did not bring about a great improvement in the protection of shareholders. Thus a Consultation Paper (No. 142) and the sequence of the law commission consultations were produced to examine this area to improve the status of minority shareholders. Those studies for example looked at other legal systems, in trying to provide more meaningful remedies to shareholders. Unfortunately however, those documents have not addressed the need for a change in the current position as far as shareholders in public listed companies are concerned. Furthermore, it seems that the U.K. market seems to have a low drive to litigation, so much so, that some investors would not use litigation even if it was available. The fact that litigation as a remedy in holding corporate managers to account appears to have failed, points to the fact that other remedies should be examined. In relation to this, the next chapter examines whether voting and the proxy system could help in achieving accountability on the part of corporate managers.

86 The Law Commission Consultation Paper No. 142 (Shareholders Remedies) and a Comparison published in 1996.
Part Two
Chapter Five

Participation in the Governance Machinery of Voting and Use of Proxies

5.1. Introduction

The current system of shareholders’ voting rights is still largely inadequate in meeting the needs of the modern corporation. Even today, it is predominantly based on the nineteen century conception of the corporation. Hence, recent attempts to improve the current voting system have been put in place, acknowledging the right of companies to use electronic communication. This has been established to help corroborate the ‘democracy system’ of the company, in an age where it is axiomatic that the use of internet and the e-mail as means of communication is becoming increasingly common. The year 2000 witnessed legislative developments, specifically the Electronic Communications Act 2000 and the introduction of the Companies Act 1985 (Electronic Communications) Order 2000. The latter contains provisions, which relate purposely to shareholders, to submit proxy forms electronically for company meetings. Furthermore, the same legislation enable the electronic medium to be used for other communications between companies and their shareholders.

The introduction of the (Electronic Communications) Order 2000 has made it clear that companies are allowed to use, for example, electronic voting. This, logically, should help in enhancing the ratio of those shareholders who do in fact vote. However, the actual effect of the above mentioned legislations is remained to be seen. It should be noted that the empirical evidence presented in this chapter was collected before the (Electronic Communications) Order 2000 came into force. Hence, voting and proxies usage might have improved since then. Furthermore,

there has been an enormous effort in the U.K. by the Government and associations such as the N.A.P.F. and the A.B.I. to encourage shareholders to use the legal machinery available to express their opinions and voice any concern. However, the current voting system is surrounded by many difficulties, mainly related to the accessibility of such a proxy and voting system and issues related to conflicts of interests between investors and corporation controllers. In fact, in listed companies, these conflicts exist between managers and shareholders, between shareholders inter se, and between shareholders and other stakeholders. Such a conflict of interests, were well-demonstrated in the 1980s, when the takeover was very popular.2

5.2. Objectives
The aim of this chapter is two-fold: first, to briefly outline the regulatory framework of proxies and voting in the light of the recent changes in developments in the C.A. '1985; and second, through analysis of the executed questionnaires for this study, to examine institutional investors and investment managers' activism in the corporate governance system, by means of participation in voting in the company G.M. The next section examines the regulatory framework of voting and proxies and electronic communication. Section 5.4 presents findings on the tendency of shareholders' usage of voting and proxies among the samples of institutional shareholders and investment managers who participated in the questionnaires of this study will be presented. Finally, conclusions will be drawn on the proxy and voting system in the U.K.

5.3. The Regulatory Framework of Voting, Proxies and Electronic Communication
Section 372 of the C.A. '1985 outlines the position with regards to the appointment of proxies and voting. The C.A. '1985 provides for numerous means of communication to be sent to shareholders, such as copies of annual accounts and reports. Yet, s. 372 is very broad, and there is no required form of notice informing shareholders of their right to appoint a proxy at general meetings. Moreover, the

2 L. Dallas, supra, n 1.
C.A. '1985 does not particularly stipulate on how shareholders should communicate their appointment of a proxy to the company. Section 372(5) CA 1985 does, however, refer to the notice appointing a proxy, to be in writing. It may be true to say that most companies have a provision in their articles of association which requires this notice to be in writing, but leaves authentication to the discretion of the board or chairperson. However, the D.T.I. has struggled with the clarity of the regularity framework of electronic and proxies and voting in the U.K. This may be linked to the use of the word 'instrument' in the provisions, relating to proxies in Table A, and in many companies’ long form articles. Regulation 60 in Table A in the Companies Regulations 1985 ('the 1985 Regulations') states: 'An instrument appointing a proxy shall be in writing, executed by or on behalf of the appointor and shall be in the following form (or in a form as near thereto as the circumstances allow or in any other form which is usual or which the directors may approve)...'. Hence, the question that the D.T.I. wished to clarify was; whether or not submitting an electronic format of a proxy would come under the definition of 'instrument'. This is because if it did not qualify then it would not be possible for the chairman of the meeting to approve it.

By way of illustration, the Interpretation Act 1978 for example, although it, strictly speaking, applies only to the interpretation of statutes and statutory instruments offers that: '[w]riting includes typing, printing lithography, photography and other modes of representing or reproducing words in a visible form, and expressions referring to writing are construed accordingly'. In the Forgery and Counterfeiting Act 1981, 'instrument' is defined, (although for the purposes of that Act), as:

(a) any document, whether of a formal or informal character; ...
(d) any disc, tape, soundtrack or other device on or in which information is recorded or stored by mechanical, electronic or other means.

Yet, it appears that the D.T.I. was not convinced that electronic format of proxies was permissible in the U.K. Thus, in the year 2000, the D.T.I. took the view that the legal position of sending documents, such as copies of annual accounts and reports, electronically by companies to their shareholders, was somehow unclear under the
The D.T.I. was particularly worried about the language of certain provisions in the C.A. ‘1985, for example, relating to annual accounts, requiring a copy of the document to be sent to all shareholders.

In light of this lack of clarity, the D.T.I. asserts that the situation should be clarified with regards to issues such as: a failure in the delivery process; timing implications of electronic delivery; and, security. The D.T.I. took the view that these issues should be dealt with in more detailed provisions, to be included in best practice rules or wider regulations on e-commerce. On 5 March 2000, the D.T.I. published a consultation letter, ‘Electronic Commerce: Change to the C.A. ‘1985’. This was published at the same time as the Electronic Commerce Bill. The letter examines electronic communication between companies and shareholders, and covers the electronic delivery of company communications, electronic voting and the appointment of proxies, and the electronic incorporation of companies. Then in March 2000, the Electronic Communications Act 2000 and the Companies Act 1985 (Electronic Communications) Order 2000 came to light. In December 2000, The Companies Act 1985 (Electronic Communications) Order 2000 came into force with the result that documents sent and signed by electronic means now have the same validity as written documents.

Section 7 of the Electronic Communications Act 2000 permits electronic signatures and certification of digital signatures on proxies. The Companies Act 1985 (Electronic Communications) Order 2000, relates to various provisions of company law, including in particular, requirements in relation to proxies. For example, clause 19 of the Companies Act 1985 (Electronic Communications) Order 2000 amends section 372 of the 1985 Act to provide that: ‘the appointment of a proxy may … be contained in an electronic communication […].’ Clause 19 of the Companies Act 1985 (Electronic Communications) Order 2000 also states that insofar as the articles of a company do not make other provisions, the appointment of a proxy may be

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contained in an electronic communication, in accordance with the provisions of Table A in the Company Regulations 1985.

In fact, Table A in the Company Regulations has been considerably amended. For example, Regulation 60, which deals with proxy forms, as originally passed, stated that: ‘The instrument appointing a proxy shall be in writing, executed …’. The words ‘the appointment of’ are now substituted for ‘the instrument appointing’, and the words ‘in writing’ have now been deleted. Unmistakably, the draftsman of the Companies Act 1985 (Electronic Communications) Order 2000, believed that it was necessary to delete both the reference to ‘instrument’ and the reference to ‘writing’. Hence, it is evident that the draftsman of the Companies Act 1985 (Electronic Communications) Order 2000, was of the view that electronic communication would not be an instrument and would not be regarded as ‘writing’. One may be inclined to believe that this is an excessively cautious view, yet clarity is no doubt better for those in the financial market.

After the introduction of the Electronic Communications Act 2000, and the Companies Act 1985 (Electronic Communications) Order 2000, one was inclined to believe that there would be a race to adopt digital signatures on proxies. Yet, according to the P.I.R.C.’s latest survey in 2001, voting levels only reached 48%. This stagnant level of voting throws into question whether the Government’s unofficial target of a 60% level of proxy voting will ever be achieved. This is a particularly poor level of voting, considering that there are many U.S.A private pension funds investing in the L.S.E. In the U.S.A, trustees of private pension plans are required to view voting rights as ‘assets of the plan.’ Thus, trustees of private pension plans in the U.S. have a fiduciary duty to employ proxy votes, solely in the best interest of the beneficiaries. Failing to reach a considered voting decision may be viewed as negligent. Though, is should be noted, that this does not mean that funds must vote. Rather, it means that a decision not to vote must be a considered

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4 P. Fidler, ibid, at 18.
and reasonable decision, which has been taken in the best interests of the beneficiaries. U.K. institutions should be required to view the right to vote as a vital, responsible and integral aspect of share ownership, not just as an adjunct, or an optional extra.

A further development in this front is currently pending in the U.S. From the 31 August 2004, the Security and Exchange Commission will enforce new rules regarding disclosure of policies and the actual voting of proxy statements by investment management, companies and mutual funds. This is no doubt, a strong acknowledgement by the Security and Exchange Commission, of the existing conflict between mutual funds and investment managers on one hand, and corporate managers on the other. This is particularly good news because historically, mutual funds often voted in support of corporate managers because of an existing commercial link.

In response to the sluggish move towards companies adopting an electronic and proxies voting system and the lack of investors enthusiasm in using such a method, the government commissioned Paul Myners to carry out an investigation into the ways to improve the process of proxy voting in U.K. listed companies. Upon the Myners Report (A Review of the Impediments to Voting UK Shares) (the Report hereafter), Myners recommended a push towards electronic voting in the year 2004. The Myners Report was met by immediate support from key trade groups of pension funds, bankers, and insurers; very important for any chance of adopting such a report. Equally important, Jacqui Smith, Minister of Trade and Industry, promised to consider the report's recommendations to reform company law.

In brief, the Report called upon issuers, institutional investors, and the intermediaries to make a conscious effort to introduce electronic voting capabilities in 2004. The Report highlighted the need for greater transparency and audit trails in proxy voting. Furthermore, the Report urged numerous reforms in the current system, which is weighed down by paper ballots. The Report emphasises the lack of

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transparency that results when investors’ accounts are bundled into a single omnibus account, recommending that beneficial owners consider insisting on having their shares registered with a unique designation. The Report notes practically, the complexity of proxy voting chains, which involve beneficial owners, investment advisers, custodians, registrars, issuers, and others.

The next section of this chapter discusses some of the empirical evidence drawn from the results of the executed questionnaires of this study, demonstrating some of the practical difficulties that face proxies and voting usage in U.K. listed companies. Yet, it should be stated that the results presented are from research conducted just prior to the Electronic Communications Act 2000 and the Companies Act 1985 (Electronic Communications) Order 2000 came into force.

5.4 Empirical Evidence on Institutional Investors and Investment Managers’ Usage of the Voting System and Proxies in Listed Companies

The method of assessing institutional investors and investment managers’ activism through participation in voting in the company G.M. was conducted by raising issues in the executed questionnaires, related to their behaviour when managing their own equity investments in house, as well as how they control and monitor the activity of outside investment managers, when employed on certain occasions. Investment managers were asked about the approach of their institutional clients and about their use of the powers delegated to them by institutions. In both cases, questions were also raised about aspects of policing by those who cast proxy votes with regards to the way those votes are in fact cast.

The N.A.P.F., A.B.I. and other organisations’ efforts to encourage investors to be more active by using the G.M., has resulted in an increase in those institutional investors who are embracing the standard proxy voting guidelines. The main aim of

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8 This acknowledges the point made by Stapledon that most of the shares controlled by ‘institutional investors’ will in fact, be voted by investment managers with delegated powers, who are likely to be making key decisions about participation in the company’s meetings, voting and proxy machinery. See, G. Stapledon, Institutional Shareholders and Corporate Governance, (Clarendon Press, Oxford, 1996).
this practice is to encourage institutional investors to use the voting system and to instruct their agents (investment managers) to attend and vote in G.M.s. Standard proxy voting guidelines can indeed result in greater usage of the voting system, when exercised efficiently. This is mainly because a high percentage of institutional investors' shares are in fact controlled by investment managers (see Appendix H Table 5.1). However, the issue of standard proxy voting guidelines is not as straightforward as it might seem. This is because, even if institutional investors have standard proxy voting guidelines, it is difficult to ensure whether institutional investors' agents (i.e. investment managers) take their clients’ proxy voting guidelines into consideration when voting. That is, of course, if they have voted at all.

The first group of questions posed to the institutional investor respondents explored the general level of control and monitoring operated by those institutions that use external managers. Tables 5.2 and 5.3 (see Appendix H), show that all investment managers and the vast majority of institutional investor respondents (79.4%) have standard proxy voting guidelines. Table 5.4 (Appendix H) however, illustrates that around 60.7% of institutional investors do not have sufficient staff and resources to ensure whether their external equity managers vote proxies, in accordance to their proxy voting guidelines. As one institutional investor stated: '[w]e ask external managers for a record of voting each quarter but do not check that they voted the way described.'\(^9\) This can only reinforce the argument that investment managers enjoy extensive power and that any assumption that institutions can directly influence company decision-making in G.M.s is somewhat questionable. It is interesting that over 60% of the institutional investors who participated in this study, seem to lack resources to monitor the adherence of their outside investment managers to their own guidelines.\(^10\)

\(^9\) Institutional investors’ questionnaire, control number 1.
\(^{10}\) It is worth mentioning that according to institutional investors’ questionnaire, control number 228, there are external agents in the financial market who have the job of checking voting practices.
The question of whether investment managers have sufficient staff and resources to vote proxies according to the proxy voting guidelines of their investor clients was asked to investment managers. The perspective, as seen from the other side of the institutional investor/investment manager divide, is interesting. All the investment manager respondents who replied to the relevant question stated that their firm had standard proxy voting guidelines. As Table 5.5 (Appendix I) shows, two-thirds (64.3%) of investment managers believed that they have sufficient staff and resources to vote proxies, according to the proxy voting guidelines of their investor clients. 14.3% of investment managers believed unequivocally that they do not, and 21.4% of investment managers believed that only sometimes, in certain circumstances or by agreement, do they have the sufficient staff and resources to vote proxies in accordance to their clients’ proxy voting guidelines. These are rather poor figures, considering the expectation that investment managers are to lead the monitoring and controlling of corporate managers.

The questionnaire then went on to explore the level of ‘hands on’ control, as opposed to overall supervision, exercised by institutions in respect of proxies delegated to investment managers. The information in Table 5.6 (Appendix I) indicates just how rare it is for an institutional shareholder to countermand the proxy voting guidelines (8.9%). Investment managers, as Table 5.7 (Appendix I) shows, asserted similar answer, none of whom were frequently asked by an investor client, (which delegated proxy voting authority to them), to vote contrary to the proxy voting guidelines. Only 71.4% of the respondents reported ‘rare or occasional’ voting contrary to the proxy voting guidelines and 28.6% had never been asked to vote contrary to the proxy voting guidelines. The issues on which institutional investors would ask their external investment manager to delegate proxy voting authority, in voting contrary to the proxy voting guidelines are related mainly to: the length of directors service contract;\(^{11}\) directors’ remuneration;\(^ {12}\) ethical issues;\(^ {13}\) and, local employment.\(^ {14}\)

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\(^{11}\) Institutional investors’ questionnaire, control numbers 107 and 133, and investment managers’ questionnaire, control numbers 126, 224, 229 and 231.

\(^{12}\) Institutional investors’ questionnaire, control number 146.
Tables 5.8 and 5.9 (Appendix I), illustrate that there is a rather low level of disagreement between institutional investors and investment managers on the way they decide on voting proxies. Only around 5% of the institutional investor respondents had ever voiced any sort of disagreement with a proxy voting decision made by their external investment manager and none of the investment manager respondents reported ever having experienced any of their clients voicing disagreement with the way they had decided on voting and proxies. The issues on which institutional investors' did report disagreement with their investment manager agents were mainly related to ethical issues or the period of directors' employment. The low level of disagreement between institutional investors and investment managers concerning voting proxies, does not necessarily mean that they agree on how voting is handled. It might rather indicate the low level of institutional investor involvement in the governance of companies. However, when institutional investors were further asked if they ever request their external investment manager(s) to return their voting proxies as a result of disagreement, just 1.4% of institutional investors said they had ever done so (see Table 5.10 Appendix I). Nonetheless, it seems that none of the institutional investors who completed the questionnaire had ever dismissed their investment managers because of their refusal to vote proxies as directed (see Table 5.11 Appendix I). Thus, limited ability to control those to whom proxies are delegated in general terms moves into much smaller numbers when specific ‘hands on’ action is considered.

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13 Institutional investors’ questionnaire, control number 416, and investment managers’ questionnaire, control numbers 222 and 227.
14 Institutional investors’ questionnaire, control numbers 738 and 852, and investment managers’ questionnaire, control number 121.
15 Institutional investors’ questionnaire, control numbers 107 and 625.
16 Institutional investors’ questionnaire, control number 197, stated that they asked their external investment manager(s) to return their voting proxies since they failed ‘[T]o provide quarterly details of when they voted against management proposals.’ It is interesting to know that some institutional investors would find it very important for investment managers to provide the details of the issues that they voted against, with regards to management proposals, which to a certain extent shows a degree of distrust in investment managers.
Results from the investment managers’ questionnaires seem to confirm this picture of limited ‘hands on’ control by institutional investors. For example, when investment managers were asked if they ever lost a client because their firm refused to vote proxies as directed, they unanimously answered ‘no’ (Table 5.12 Appendix I). Clearly, the smaller number of respondents in the investment managers group indicates that caution is required in using these figures. It may also be the case that the use of the word ‘ever’ in some of the questions, accounts for the number of ‘don’t know’ – on the basis that the firm may have a long history so that the person who answered the questionnaire was unaware of the relevant information beyond his/her employment date. However, even taking account of these caveats, Table 5.12 shows that none of the investment manager respondents had ever lost a client because of this issue, none of whom had been asked more often than ‘occasionally’ to vote contrary to voting guidelines, and none of whom had ever had to return a proxy, or that a client has voiced disagreement with a voting decision.

Of course, none of this proves that investment managers act against the wishes of institutions. However, in the absence of a belief by institutions regarding the adequacy of resources to monitor whether guidelines are followed, one questions this explanation. These results give some indication of the level of activism on the part of institutions and raises strong doubts about their role as ‘micro’ level monitors and activists in using the constitutional machinery in particular listed companies. Table (Table 5.13 Appendix I), indicates that around 78.5% of investment managers exercise their voting rights and proxies always or frequently, while 21.5% rarely or occasionally do so. Thus, according to the accounts given by the investment manager respondents, there is a degree of activism in terms of voting. Nevertheless one would still expect a higher percentage of those who practice voting and proxies.

The questionnaires then explored how far this activism went in terms of other actions; such as proposing resolutions, the willingness to vote against board recommendations and selling, due to disagreements. These issues were raised with institutions in respect of investments managed in house and sought to test similar issues with investment managers, posed by slightly different questions. Both groups were also asked about monitoring corporate management’s compliance with proxy
instructions. Approximately only 29% of the institutional investor respondents in the study managed equity portfolio in house, whether whole or partial. The majority of institutional investors and investment managers, as Tables 5.14 and 5.15 show, have never proposed a resolution at a company G.M. This is not a very surprising result, given the rarity with which such action is in fact ever taken. When institutional investors were asked about the frequency with which management proposed to meet with them to negotiate a settlement when they propose a resolution, around 56% of respondents claimed that management meet with them either frequently or occasionally, whereas 44% of respondents stated that management either do not propose a meeting or propose a meeting only rarely (Table 5.16 Appendix I). The results from the investment manager questionnaires were exactly the reverse; 44%, if the answers of those participants who did answer this question are ignored, of whom stated that management meet with them either frequently or occasionally and 56% of whom claimed that management either do not propose a meeting or propose a meeting only rarely (Table 5.17 Appendix I).

When institutional investors and investment managers were asked about whether they have a systematic practice for monitoring management casting their proxy vote as instructed, 16 out of 24, i.e. two thirds of institutional investor respondents, have no systematic means of checking on whether corporate management have, in fact, voted their proxies in accordance with instructions (Table 5.18 Appendix I). Similarly, as Table 5.19 shows, if the answers of those participants who did answer this question are ignored, that over 61% of investment manager are without any systematic means of checking on whether corporate management have, in fact, voted their proxies in accordance with instructions.

Of course, there is no quandary with investment managers and institutional shareholders checking on whether management have cast their proxy vote as instructed, if resolutions are passed on a show of hands. This is because proxies are only counted on a poll and only those present would vote on a show of hands. However, according to some of the respondents, when a resolution requires a poll, it
becomes rather more difficult to monitor how proxies are voted.\textsuperscript{17} Institutional investors and investment managers seem to rely on a custodian / registrar to make sure that proxies were voted correctly.\textsuperscript{18} According to the results of the questionnaire, some institutional investors go a step further by performing a random check on how their proxies were voted.\textsuperscript{19} It is probable that one of the reasons for failing to check on how proxies are voted is the lack of staff and resources to monitor whether management fulfil proxy voting guidelines or not.\textsuperscript{20}

In relation to this, it is interesting to compare the results of the two groups of respondents on the question of whether shares have ever been sold in response to a failure by management to act on their 'recommendations'. Tables 5.20 and 5.21 (Appendix I) show, if the answers of those participants who did answer this question are ignored, that around 66\% of institutional investors and about 43\% of investment managers had never sold shares in response to a failure by management to act on their 'recommendations', and a substantial majority of both institutional investors and investment managers (about 86\%; if the answers of those participants who did answer this question are ignored; of institutional investors and about 79\% of investment managers) had either, never, or rarely done this. Thus, selling, while it may be a response to general problems of poor performance, does not seem to be used on specific issues where suggestions made to management are ignored. This is rational, if there is no other reason to believe that the performance of the company has been poor or that the shares will lose value.

\begin{itemize}
\item \textsuperscript{17} Institutional investors' questionnaire, control numbers 3 and 432.
\item \textsuperscript{18} Institutional investors' questionnaire, control number 104: 'Sample check with registrars as part of compliance audit.'
\item Institutional investors' questionnaire, control number 277: 'Via custodian.'
\item Institutional investors' questionnaire, control number 217: 'Votes cast via custodian – examining methods of receiving feedback.'
\item Institutional investors' questionnaire, control number 298: 'Check via custodian / registrar. But not particularly accurate.'
\item Institutional investors' questionnaire, control number 418: '... we would either vote ourselves or give the proxy discretion.'
\item \textsuperscript{19} Institutional investors' questionnaire, control numbers 104, 260 and 431.
\item \textsuperscript{20} Institutional investors' questionnaire, control numbers 133 and 217, and investment managers' questionnaire, control number 185.
\end{itemize}
The overall picture to emerge so far on the use of the company's constitutional machinery by either institutional investors or investment managers, emphasises the limits of their role. It indicates the importance of investment managers, to whom power is extensively delegated, but shows a limited use of these mechanisms. This is perhaps no great surprise, given the cost and difficulty of using the machinery. It may point to the significance of collective action by the agreement of guidelines by such bodies as N.A.P.F. and A.B.I., which facilitate action by member institutional investors and their investment managers, when a company is about to break one of the guidelines – probably by voting rather than proposing resolutions. However, the issue of how effective the casting of votes on behalf of institutional investors by investment managers is, or how proxies are voted on behalf of either group by company management is monitored, appears to raise questions about how the intention of the holder of the shares feeds through into actual votes being performed.

5.5 Conclusions

This chapter briefly examined the regulatory framework of proxies and voting in U.K. listed companies. Moreover, this chapter demonstrated with the support of empirical evidence, some of the complications and difficulties in the usage of proxies and voting in U.K. listed companies. There is no doubt that the D.T.I.’s efforts in clarifying the situation with electronic use of proxies should be praised as a step in the right direction. It is now crystal clear that companies could adopt a policy of accepting an electronic form of proxies and signatures from their shareholders. Yet, such effort could be meaningless if shareholders, particularly institutional shareholders, do not make use of the process of voting and proxies.

Moreover, there are many more problems in the current voting and proxy system and the use of ‘democracy’ in U.K companies. The Myners Report (A Review of the Impediments to Voting UK Shares) addressed issues related to the problem of using the current proxy and voting system in U.K listed companies. Other than urging companies, institutional investors, and the intermediaries to make conscious efforts to introduce electronic voting capabilities in 2004, the Report’s recommendation of
the need for greater transparency and audit trails in proxy voting should most likely be enforced. Unfortunately however, while the U.S. is moving away from solely requiring private pension schemes to disclose how they vote, to include mutual funds and investment managers, the Myners Report stopped short of recommending mandatory voting on institutional investors. A move in the same direction of the U.S., nonetheless, should be welcomed in the U.K. The empirical evidence presented in this chapter demonstrates that there is a great need for institutional investors to be more active in their usage of their voting rights. A greater and more meaningful effort, rather than box ticking, needs to be delivered if we are to achieve a form of a 'sound democracy system'.
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Chapter Six

Dialogue between Institutional Shareholders and Investment Managers with Company Management

6.1. Introduction

In a fast moving market, regulations always need to be refocused and changed in response to, and accordance with movements and developments of that particular market. The L.S.E. is arguably the most developed stock market in the world today. Recently, the U.K. Government conducted an extensive overhaul of the financial market regulations, aiming to maintain the leading status that the L.S.E. already enjoys. The most relevant changes made to the Financial Services and Markets Act 2000 (F.S.M.A. 2000 hereafter) concerning this chapter are: first, the introductions of the market abuse civil sanctions; and second, the new powers that the F.S.M.A. 2000 vested in the Financial Services Authority (F.S.A. hereafter).

One can argue that corporate disclosure and dialogue, with market participants in general and shareholders in particular, are important in retaining a good and sound corporate governance system. It goes without saying that in order for a shareholder to be able to effectively monitor corporate managers, he/she needs to be equipped with good information. In another words, effective monitoring is dependant on the availability of good information concerning corporations’ affairs. Good information is usually obtained from one of two channels. The first is through the continuous obligation of corporations to disclose information and keep the market updated, allowing the market to reflect on such information, providing a more ‘accurate’ account of corporations’ share prices. The second is through corporations’ dialogue with market participants, such as shareholders. A corporate manager can use dialogue with shareholders to make him/herself aware of how the market perceives the company’s performance and its’ managers, and hence, probably avoid conflicts with shareholders. Market participants, such as shareholders, could also use this process to express content or discontent with the way the corporation is managed.
Dialogue and disclosure are 'two sides of the same coin'. Or more precisely, dialogue can be seen as part of disclosure. A clear link between the two can be demonstrated by the market practice, in which dialogue usually takes place either to discuss information that has been disclosed, or demand a company to release more information concerning that which has already been disclosed. Hence, corporate dialogue with market participants can be divided into the following two channels: the first channel, which is the formal channel is called 'periodic reporting'; and the second channel is the informal channel of disclosure, namely, 'selective briefing', also known as 'private briefing'. The F.S.A. Listing Rules are the main source that governs the formal channel of disclosure. It is also supposed to be the main source of information about the listed companies in the market. The second channel of disclosure entails informal contact with investors and analysts through conferences, conference calls, site visits, roadshows, and 'one-on-one meetings'.

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1. The Listing Rules are mainly concerned with listed companies' obligations to disclose price sensitive information.


Up until recently, academics’ commentary on both sides of the Atlantic reported that, listed companies often used informal channels of disclosure to reveal information to their significant shareholders, particularly significant institutional shareholders and investment managers. Moreover, it is alleged that some of the information announced to significant shareholders was in the past, occasionally non-public, price-sensitive information. However, since the F.S.M.A. 2000 came into force, 1 December 2001, U.K. listed companies have had, (or more precisely, are supposed to have had), to review the scope, method and nature by which they disclose information to the market. The introduction of civil sanctions by the F.S.M.A. 2000 and the line that the F.S.A. has currently taken, ought to alarm corporations and make them reconsider whether or not to use methods of disseminating information, such as private briefing. There is a clear signal, as discussed below, that the F.S.A. is taking rather a tough stance against these so-called 'private meetings'.

As well as the Listing Rules (L.R. hereafter), dialogue between investors and corporate managers in listed companies is currently subject to: (a) criminal offences relating to 'insider dealing' and 'misleading statements' which are mainly governed by the 'Criminal Justice Act' 1993 (C.J.A. 1993 hereafter); (b) the new 'market abuse' regime; (c) the new regime governing 'financial promotion' (The latter two are organised by the F.S.M.A. 2000); and, (d) the risk that recipients of information could be considered as shadow directors, which is governed by ss. 317(8), 318(6), 319(7), 320(3) C.A. '1985; and ss. 206(3), 214(7) IA '1986. Moreover, the F.S.A. has recently announced that ‘selective briefing’ is unfair; indicating its intention of pursuing listed companies that do not apply rules of fair disclosure.4

This chapter focuses on the effects of the recent developments in the regulations, governing private meetings and the stance of the F.S.A. to them. Specifically, this chapter examines the ability of institutional investors and investment managers to become involved in corporate governance and monitor corporations’ management, on both an individual and collective level. Such discussion sheds light on the

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3 ibid.
4 See the discussion on this point later in this chapter.
validity of the widely accepted allegation among academics, that dialogue between shareholders and corporate managers takes place behind closed doors in U.K. listed companies.\(^5\)

This chapter concludes that although the recent developments in regulations and the F.S.A.'s stance on private meetings might be useful in ensuring fairness among shareholders, both factors still have a negative affect on institutional shareholders and investment managers' ability and willingness to monitor and control corporations and their managers. Furthermore, this chapter concludes that shareholders in general and institutional investors and investment managers in particular, are faced by many legal obstacles that could hinder them (even when willing) in holding corporate managers to account. Certainly, such a conclusion questions the validity of the allegation that in the U.K., dialogue between shareholders and investment managers with corporate managers takes place behind the scenes.

6.2. Objectives

The aim of this chapter is three-fold: first, to examine the legal framework of dialogue between investors and corporate managers. This is achieved by presenting a discussion on the U.K.L.A., L.R., and shareholders' rights to information, as well as the legal background to informal dialogue, in relation to insider dealing and market abuse; second, to provide analysis on the basis and frequency of dialogue between investors; particularly institutional shareholders and investment managers; and corporate management. In doing so, this chapter introduces findings based on the responses of institutional investors and investment managers to the executed questionnaires of this study on dialogue and communication between investors and management. The main aim of conducting the questionnaires was to provide an insight into institutional investors and investment managers' current practices on dialogue with corporate management; and third, to examine the accessibility that institutional investors and investment managers have to collective action. This is achieved by presenting the possible legal limitations of collective action and

empirical evidence on problems that face shareholders when considering collective action.

This chapter consists of seven sections. The third section discusses listed companies’ formal means of disclosing information. The fourth section assesses the importance of dialogue between investors and corporate managers; offering an evaluation of the effects of the legal constraints (that come from both soft and hard law) on dialogue between institutional shareholders and investment managers and corporate management. The fifth section explores the basis of dialogue between institutional shareholders and investment managers, and corporate management in U.K. public listed companies. The sixth section examines investors’ collective action against corporate management, and finally, the seventh section presents a summary of the chapter, conclusions.

6.3. Disclosure: the Formal Position

6.3.1. Regulation of the Disclosure of Unpublished Price Sensitive Information in the U.K.

The general requirement by the F.S.A. is that listed companies announce all ‘material’ developments without delay. The L.R. published by the F.S.A. spell out the general requirements concerning disclosure obligations as follows:

9.1 A company must notify the Company Announcements Office without delay of any major new developments in its sphere of activity which are not public knowledge which may:
(a) by virtue of the effect of those developments on its assets and liabilities or financial position or on the general course of its business, lead to substantial movement in the price of its listed securities;
(b) in the case of a company with debt securities listed, by virtue of the effect of those developments on its assets and liabilities or financial position or on the

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6 The meaning of the term ‘material’ is to some extent clarified below and is the subject for further discussion later in this chapter. However, put simply, in most cases ‘material’ refers to that information that is likely to affect company share price.

7 The general requirement in paragraph 9.1(a) is derived from a European Community Directive. This is set out in Council Directive 79/279/EEC of 5 March 1979, Schedule C paragraph 5(a) and Schedule D paragraph A4(a), which is entitled ‘Admissions Directive’.
Thus, the initial and main issue addressed by the L.R. with regards to corporate announcements, is that a notification is served to the Company Announcements Office (C.A.O. hereafter), immediately and without any undue delay. The requirement set out in paragraph 9.1, is further widened by paragraph 9.2 to take on board unpublished price sensitive information, relating to changes in the issuer’s financial condition, the performance of its business and the issuer’s expectation of its performance. In addition, Paragraph 9.3(a) requires that any information so notified to the C.A.O., is complete and neither misleading, nor false or deceptive. The L.R. provide however, exceptions to the general obligation of disclosure. The exceptions that are set out in paragraphs 9.4 and 9.15 of the L.R. relate to confidential matters in development or negotiation and to occasions when the C.A.O is closed, respectively. Paragraph 9.4 states:

9.4 A company need not notify to the Company Announcements Office information about impending developments or matters in the course of negotiation, and may give such information in confidence to recipients within the categories described in paragraph 9.5. If the company has reason to believe that a breach of such confidence has occurred or is likely to occur, and, in either case, the development or matter in question is such that knowledge of it would be likely to lead to substantial movement in the price of its listed securities, the company must without delay notify to the Company Announcements Office at least a warning announcement to the effect that the company expects shortly to release information which may lead to such a movement.

9.5 The categories referred to in paragraph 9.4 are: the company’s advisers and advisers of any other persons involved or who may be involved in the development or matter in question; persons with whom the company is negotiating, or intends to negotiate, any commercial, financial or investment transaction (including prospective underwriters or places of securities of the company); representatives of its employees or trades unions acting on their behalf; and any government department, the Bank of England, the Monopolies and Mergers Commission or any other statutory or regulatory body or authority.

The company must be satisfied that such recipients of information are aware that they must not deal in the company’s securities before the relevant information is made public. A very important point relevant to the discussion throughout this chapter is that institutional investors and analysts are not among what paragraph 9.5 of the L.R. recognises as the categories of persons to whom confidential, non-public,
material information can be given, and the circumstances in which it can be given.  

The U.K.L.A requires that all announcements be made via the C.A.O., prior to or simultaneously with another announcement by any other method. However, Paragraph 9.15 of the L.R. accepts that it is not always possible to comply with both this requirement and the requirement that states that announcements are made without delay. Paragraph 9.15 of the L.R. provides the following:

9.15 When an issuer is required by the Listing Rules to notify information to the Company Announcements Office at a time when the Company Announcements Office is not open for business, it must ensure that there is adequate coverage of the information by distributing it to not less than two national newspapers in the United Kingdom and two newswire services operating in the United Kingdom. In addition, the issuer must ensure that the information is notified to the Company Announcements Office, for release as soon as it re-opens.

The C.A.O. operates the L.S.E.'s Regulatory News Service; an electronic information dissemination service for publishing announcements that are required under the L.R. It is estimated that the C.A.O. deals with and publishes an average of six hundred announcements a day, from approximately 2,292 listed companies on the L.S.E.'s main market. This means that the C.A.O. deals with about 156000 announcements a year; i.e., about 68 announcements a year on average, for each company listed, which equals the average of 1.4 announcements per company, a week. This is a large number, which might lead one to think that it reflects highly liquid news in the market. However, not all that is disclosed is material information. Moreover, one must bear in mind that not all announcements are significant.  

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8 Paragraph 9.6 of the L.R. states: ‘Information that is required to be notified to the Company Announcements Office must not be given to anyone else before it has been so notified, except as permitted by paragraphs 9.4 and 9.15.’  

Paragraph 9.6 is the basis of fair disclosure that Mr Davies announced. This paragraph of the L.R. is not derived from an EC Directive. See the discussion on Mr Davies' announcement later on this chapter.

9 The number of listed companies as for the year 1999, the figure is taken from C. Van der Elst, ‘The Equity Markets, Ownership Structures and Control: Towards an International Harmonization?’, in K. Hopt, and E. Wymeersch, Capital Markets and Company Law, (Oxford University Press, Oxford, 2003), at 7.

10 When following what is announced, one might find that sometimes even a resignation of a junior manager is announced. Nonetheless, the credit for issuers' announcements in the C.A.O. is the U.K.L.A requirement that listed companies must announce all material non-public information without delay.
fact some issuers may still struggle with the decision to issue negative news and some issuers are even reticent about announcing positive news.

Furthermore, the limitations of the information that financial reporting and public disclosure mechanisms offer about a company's status have recently been acknowledged.\textsuperscript{11} Financial reports and other public disclosures are often said to be too late and too narrow, in that they do not satisfy the needs of a wide range of corporate stakeholders.\textsuperscript{12} The company financial report is further accused of adding little value, in general, since it is claimed that it is purely historical, and it is rather meetings with investors that add some value to the existing body of information available to the market.\textsuperscript{13} The company financial report could also be criticised on account of often being too complicated for investors to understand, particularly private investors.

The introduction of summary financial reports might be the right step to overcome the latter problem.\textsuperscript{14} However, it is little improvement for the market to rely solely on financial reports, unless there is statutory interference to improve the quality of financial information disclosed in such financial reports. The accounting standards bodies' boards such as the Institute of Chartered Accounts in England and Wales and Institute of Chartered Accounts in Scotland are working to improve the quality of financial reporting and to make it more user friendly.\textsuperscript{15} Although the quality of information published in the financial report is a very important subject in the area of corporate governance, it is beyond the objectives of this thesis to discuss the matter further. The notorious problems associated with Enron in the U.S.A. have led

\begin{thebibliography}{9}
\bibitem{15} ibid.
\end{thebibliography}
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to changes both at E.U. and U.K. level in the area of accountancy standards16. However, recent changes have not affected the position discussed here.

The requirements on listed companies concerning disclosure are mainly organised and governed by the City Code on takeovers and mergers, the stock exchange L.R. – handbook that contains the so-called ‘blue book’ and the ‘yellow book’ and the guides related to information dissemination. The current system of disclosure was largely developed before the advent of the information revolution. Traditionally, the Stock Exchange has insisted that it publishes figures as a ‘prelims’ on the same day that the company’s board meets to deliver the final profit/loss report. The reason for this is to avoid insider dealing. The full report and accounts would follow later. Companies listed on the L.S.E. are required to produce ‘interims’ including a profit and loss account for the first six months of the year. Chapter 9 of the L.R. leave it to the L.R. combined with the Price Sensitive Information Guide to develop the meaning of what should be disclosed in the C.A.O. and when, which is the subject matter for discussion under the next title.

In the U.K., although the F.S.A. and its predecessors have imposed requirements regarding the disclosure of material, non-public information since the 1970s, the U.K.L.A. has not, in the past, pursued selective briefings.17 If anything, the F.S.A. has encouraged dialogue between corporations and market participants, subject to the condition that it does not contravene market integrity in any way, such as by facilitating insider dealing. As mentioned above in brief, under Chapter 9 of the U.K. L.R., companies are required to disclose certain material, non-public

16 See the Companies (Audit, Investigation and Community Enterprise) Bill 2004 at:
   <http://www.parliament.the-stationery-office.co.uk/pa/ld200304/ldbills/051/2004051.htm> (May, 2004);
   DTI proposals at: <http://www.dti.gov.uk/cld/post_enron.htm> (May, 2004);
   <http://europa.eu.int/comm/internal_market/company/board/index_en.htm> (May, 2004);
17 This is a contrast to the City Panel on Takeovers; see: < http://www.simmons-simmons.com/display_home/takeover/samples/Takeover_Panel.ppt > (May 2003). The Code does deal with this question in the context of takeovers.
information. Paragraph 9.1 of the L.R. requires immediate disclosure to the C.A.O. of any major new developments that may 'lead to a substantial movement in the price of its listed securities.' Additionally, Paragraph 9.2 of the L.R. requires that a listed company notify the C.A.O. of non-public information concerning any 'change in the company's financial condition or in the performance of its businesses or the company's expectation as to its performance' that, if made public, would be likely to lead to a substantial change in share price.

6.3.2. The L.R. and the Price Sensitive Information Guide

The L.R., such as the obligations under chapter 9 to make announcements, have remained largely unchanged by the F.S.M.A. 2000. The questions that a company asks itself when deciding whether to make an announcement or not include: first, what information it should contain; and second, when it should be made. Companies should have consistent procedures for determining what information is sufficiently significant for it to be price sensitive and releasing that information. It is the companies' responsibility to make arrangements to keep price sensitive information confidential until it is announced, and they must not allow this information to leak.

The relevant changes that the F.S.M.A. 2000 has introduced, however, is that it has sanctioned the F.S.A. with significant new powers to investigate and discipline breaches of the L.R. The F.S.A. now has the command to: (a) establish a formal investigation if it suspects that a breach of the L.R. might have taken place. It may interview witnesses and compel both listed companies and third parties to disclose documents and information. This information may then be disclosed to the F.S.A. or to other regulators; (b) apply for 'restitution orders' and injunctions against both listed companies and their directors; and (c) publicly censure and impose unlimited penalties on listed companies, directors and former directors who have knowingly been involved in breaches of the L.R.

20 On 17 January, 2001, the F.S.A.'s proposed changes to the L.R. under the Consultation Paper 81, which is entitled 'Proposed Changes to the Listing Rules'. Market participants were given the chance to voice their views about the proposed changes and the period for consultation responses, closed on 16 March, 2001. The L.R. was still undergoing change at the time of writing this thesis.
In summary, the L.R. require corporations to disseminate material information without delay. Furthermore, regulatory announcements in the U.K. must all be made centrally via the C.A.O., simultaneously or prior to an announcement by any other method. The problem, however, still remains that companies can keep price sensitive information ‘close to their chests’ and not disclose it to the public. Limited disclosure restricts markets participants’, (including shareholders), ability to monitor corporate performance and corporate managers’ competence. In relation to this, the next section examines shareholders’ rights to information, particularly to material, price sensitive information.

6.4. Dialogue: Shareholders and the Right to Information

As mentioned above, there is no obligation upon a company under the L.R. to disclose any unpublished price sensitive information to individuals. In fact, paragraph 9.6 of the L.R. requires exactly the opposite, stating:\(^{21}\)

9.6 Information that is required to be notified to the Company Announcements Office must not be given to anyone else before it has been so notified, except as permitted by paragraphs 9.4 and 9.15.

The way the constitutional machinery for disclosure and dialogue has been developed in U.K. listed companies is that; on one hand there is the above mentioned requirement for disclosure, governed by the L.R. that requires price sensitive information to be disclosed through the C.A.O. On the other hand however, company law perceives that the formal means for dialogue under the C.A. ‘1985 takes place in the form of the general meeting (G.M. hereafter) (see, chapter 5).

Of course, in addition to the above-mentioned two means of dialogue and disclosure, the C.A. 1985 requires presentation of an annual report and accounts to the annual G.M. (A.G.M. hereafter) and that they are filed with the Registrar of Companies. This is an additional disclosure requirement not found in the L.R., but is intimately linked to the functioning of the G.M. and involves the disclosure of historical information, rather than current information. Other than the above-mentioned means

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21 Paragraph 9.6 is the basis of fair disclosure that Mr Davies announced, which is discussed in more depth later in this chapter. This paragraph of the L.R. is not derived from an E.C. Directive.
of dialogue and disclosure, there is neither statutory law nor case law obligation placed on companies for further dialogue or disclosure. In fact, there is not only no requirement on companies to disclose price sensitive information to shareholders, other than in the above-mentioned means, but they are also under no obligation to disclose any unpublished information to shareholders. This goes as far as to include information that is not price sensitive in its nature: so-called, ‘soft information’.

The fact that companies are under no obligation to give shareholders information other than the requirements set by the C.A. ‘1985 and L.R., could obviously be justified on the basis of the legal maxim that corporate managers are agents for the company which is a separate legal entity from its shareholders, rather than to individual shareholders. This approach exiles contractual theory, and convenes with the theories of corporate communitaire and corporations concession. Moreover, although in general terms the collective body of shareholders within private or even public unlisted companies (in the form of the G.M.) should have the ability to force the board of directors to disclose information to them, in listed companies this is not the case when the information asked for is price sensitive information. The reason being, that if management were to disclose such information without going through the C.A.O. before hand or, simultaneously with another announcement, it would be in breach of the L.R., which may subject them to sanctions.

Despite the fact that companies are not obliged to offer other than what is offered in financial reports and other public disclosures, they may choose to disclose information to an individual shareholder or analyst in order to maintain friendly relations. On the other hand, such information may be readily available to some shareholders due to, good relations with corporate managements or, from nominees appointed by them in the board of directors. Although, the widely used name for this information is ‘voluntary’ or ‘private’ disclosure, in fact, calling such information voluntary may not be accurate all the time. This is due to the fact that such information may indeed be offered, in some cases, due to pressure placed on companies by shareholders to disclose more information with regards to company performance. Corporate managers may be led to disclose such information because

22 See, chapter three for further discussion on corporations theories.
of the myth attached to voluntary disclosure; 'no news is bad news.'\textsuperscript{23} Hence, corporate managers may feel obliged to disclose such information, not to be perceived as hiding bad information. The amount of institutional investors' investments in a given company often puts them in a better position to acquire such information, i.e. the more institutional investors there are within a company, the more power they have to exert control over the amount of information they receive.

\textbf{6.4.1. Importance of Dialogue between Institutional Investors and Investment Managers and Corporate Managers}

The sophistication of investors in the U.K. capital market drove companies to invest in good relations with their investors, which subsequently led to constant company-investor relations in the 1990s.\textsuperscript{24} This is called investor relations (IR hereafter). In particular, companies are thought to invest time in the development of a strong relationship with institutional investors, investment managers and analysts.\textsuperscript{25} This is because collectively, institutional investors and investment managers hold and manage quite a large stock of the companies listed on the L.S.E, as one company explained: 'when you reckon that 50 institutions hold 50 or 60% of your shares they have a right to want to talk to you.'\textsuperscript{26}

The influence of institutional investors has also been acknowledged by many academics, including Gaved, who observed that institutional investors held 75\% of shares in the major U.K. companies in 1996, with U.K. institutional investors owning approximately 60\% of shares in U.K. companies.\textsuperscript{27} The reason for analysts'  


\textsuperscript{25} See, C. Marston, \textit{Investor Relations Meetings}, supra, n 2, at 95.

\textsuperscript{26} ibid. at 88.

\textsuperscript{27} It must be said that U.K. institutions included in Gaved's work, such as Mercury Asset Management and Morgan Grenfell Asset Management, are controlled by overseas institutions. Gaved's research showed that 50 financial institutions owned half of the U.K. equities in the U.K. stock market, the top 20 owned about a third of the market, and the top 10 about a quarter, with the largest, Mercury Asset
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involvement, on the other hand, is that they help in marketing the company’s shares and assist in setting the right price for them, based on information received from companies. The empirical data collected for this study shows that there is wide acceptance among significant investors and investment managers that a form of dialogue should take place between investors and corporate managers. For example, 85.7% of the investment manager respondents in this study, thought that investors should meet with corporate managers to discuss corporate performance (see Table 6.1, Appendix I).\textsuperscript{28}

One can speculate on the reasons for the popularity of dialogue among investors. A very important reason could be that investment managers use dialogue to monitor corporate management. Effective monitoring requires that information be accessible, intelligible, up-to-date and relevant. Subject to the willingness of corporate management to provide information and the legal restrictions on price sensitive information, such information can be provided to investors through dialogue. For example, shareholders who hold dialogue with corporate management might be able to evaluate management performance and assess whether management is keeping to its promises. Investors could do this by testing the consistency in the answers of management when compared to previous responses, and divergences in answers within the management team themselves. Furthermore, if dialogue takes place through a meeting, the means to judge the level of co-operation within the management team might be available to shareholders.

Dialogue should be equally popular among corporate managers. In a competitive market, companies would enhance the prospect of marketing the companies’ shares to investors, through providing the means of engaging investors in company business. This is very important if companies are to retain investors and secure

\textsuperscript{28} The ratio might have been even higher if the question did not specify the method of dialogue in meetings.
investors' capital for future projects. The competitiveness of the market as a means towards dialogue has been recognised by some companies and institutional investors. It is evident in the statements below that some companies and institutional investors perceive dialogue as a way of convincing their investors to provide capital.

For instance, one company stated:

The advantage is being accessible... If you expect people to buy your stock you should be there, prepared to do questions and answers, prepared to do a sales pitch. Meetings give that opportunity and it means if there is a story out there that you do not agree with, you can stop it.

This view was echoed by an institutional investor, who in affirming that companies do take the route of dialogue as a method of marketing their shares, asserted:

In an ideal world they will send out one annual report and accounts and get on with running the business. Perhaps they get to present their case as they are competing for our capital over X plc. They want our investment rather than Y plc having it, so they want to tell their story to attract your capital. They are selling their business to us really.

Good relations between management and investors could also secure the loyalty of investors to the company in the face of a hostile takeover bid. Holland by means of empirical research, argues that corporate communication decision policies are driven by strategy and corporate financing policy. Holland makes the case that the primary purpose of corporation managers when communicating with investors, is to improve corporate financing capability and defences against takeover threats. For example, Holland quoted one of the companies he interviewed as saying:

29 Watts and Zimmerman argue that market failure might be prevented if finance directors have the incentive to provide information to shareholders. See, R. Watts, and J. Zimmerman, Positive Accounting Theory, (Englewood Cliffs, NJ: Prentice Hall, 1986).

30 This quotation, which was taken from C. Marston's book (Investor Relations Meetings, supra, n 2, at 87), is the opinion of a company responding to a question regarding the advantages and disadvantages for companies in holding investors relations meetings.

31 ibid. at 91.

32 R. Barker, supra, n 2.

33 J. Holland, 'Private Disclosure and Financial Reporting', supra, n 2. For more sources about the importance and aim of private communication see, J. Holland, Corporate Communications with Institutional Investors, supra, n 2; see also, J. Holland, 'Private Voluntary Disclosure', supra, n 2.
We don’t have any problems with our UK financial institutions. This even keel with every one of our institutions is because our financial performance has been going well and, of course, this improves the nature of relationships. Good relationships like these are especially important when water moves a lot. For example, when the market suddenly changes or when there are merger waves. And the markets change a lot, the sentiment may not change too much against us because we have this solid core of institutions on our side. When there are merger waves we may have their help. It’s a defence for when we wish to take somebody else over. The close contact with the institution means the market gets a better understanding of the value that’s in the business, or the lack of it in a company. If you don’t talk to them then your credibility declines and the market takes the worse view.  

Nonetheless, investors’ loyalty to the company could be counter productive in some cases, particularly if the company subjected to a takeover bid is under performing because of bad management. Therefore, it could be argued that securing investors’ loyalty, although in some cases good for management, might not necessarily be advantageous to the company itself. However, contractualism theorists would argue that such a risk is rather insignificant in a business world driven by profit making. It could be further argued that institutional investors and investment managers’ own managers are unlikely to jeopardise their positions with their trustees and customers, just by being loyal to bad management. This view highlights the core of the theme discussed throughout this thesis: ‘who guards the guardians?’ (i.e. fund managers’ managers). It is rather simplistic to say that the trustees and customers of institutional investors and investment managers hold a magic solution to this question. There is no doubt, however, that trustees and customers of institutional investors and investment managers, if provided with information, could play a role in demanding that fund managers be active in monitoring corporate managers.

Furthermore, in some cases, companies could probably benefit from investors’ comments and feedback based on their experiences. Dialogue is particularly good for a company in the sense that, it might acquire useful information on how its performance and polices are perceived from an outsider’s point of view. Being able to gauge investor and market sentiment about company performance and policy, by holding dialogue with investors, might direct companies to alter their policies to fit investors’ expectations, prospects and interests. Some companies might even view

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34 ibid.
dialogue with investors as a useful challenge and safety valve to avoid believing one’s own propaganda.\(^{35}\) Last but not least, one could argue that shareholders could use dialogue to ask management to interpret certain events and information that might help to increase market understanding of the company. Allegedly, this in turn would result in improving market transparency to reflect a company’s ‘true’ share price.

Yet, dialogue with shareholders is not faultless. It is ‘legitimately’ true that most shareholders would concentrate on their own value, ignoring the prospects and interests of other groups within the company. It could be further argued that even different groups of shareholders have different interests. For example, institutional investors and investment managers’ interests might be different to those of private investors.\(^{36}\) Hence, there are some disadvantages of dialogue. Generally speaking, dialogue is costly, not least because it consumes some of management’s precious time that might otherwise be spent enhancing company performance.\(^{37}\) However, one should not exaggerate this point. Empirical research, for example, suggests that such a disadvantage is manageable, i.e., the cost of meeting investors does not cause a significant problem to companies.\(^{38}\)

Furthermore, one of the supposed problems brought about by dialogue is that such a channel of communication could be used by some investors, as a way of placing

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36 This issue is discussed and analysed in more depth in section 6.6.3 of this chapter.

37 The cost here is not only referring to the cost of management’s time that is spent in communication with financial institutions and analysts, but also the cost of meetings which befall on the company from other related factors, such as, writing internal company price sensitive information codes, the costs of setting up the technology needed, the place for communicating with investors, and the legal and administrative advisory costs related to communicating with investors etc. See, J. Holland, ‘Private Disclosure and Financial Reporting’, supra, n 2.

38 The results of Marston’s study illustrated that visits made by investors to the company were in actual fact more expensive than group meetings (this point is explained further later, in this chapter).

Also, as Marston suggested, there is an extra expense because of the practice that companies are expected to pick up the bill for the travel costs of analysts (such as brokers). It is not clear however, if the same applies to institutional shareholders and investment managers. See, C. Marston, *Investor Relations Meetings*, supra, n 2, p. 88.
pressure on corporate managers to release information that could potentially be utilised by rivals.\textsuperscript{39} There is also the risk of insider dealing upon disclosure of price sensitive information to investors or a group of investors that a company has dialogue with. Finally, there is the risk of releasing price sensitive information that would make investors insiders and therefore, unable to trade in shares.\textsuperscript{40}

In weighing up the advantages and disadvantages of a company holding dialogue with investors, one can only conclude that the advantages outweigh the disadvantages. That is of course, subject to the way that dialogue is conducted, for example, the extent to which a company gives the opportunity to all investors to participate in dialogue.\textsuperscript{41} If more emphasis is to be placed on the corporate governance role of institutional investors and investment managers in the wake of the Higgs\textsuperscript{42} and Myners\textsuperscript{43} Reports, dialogue will probably need to remain part of the picture and its role may increase. This makes clarity about the legal constraints within which it is to operate vitally important. These issues are the main subject of discussion under the next title.

\textbf{6.4.2. Conduct, Frequency and Basis of Dialogue between Institutional Investors and Investment Managers and Corporate Management in the U.K.}

Previous research suggests that corporate managers are selective in choosing investors and analysts with whom they hold dialogue.\textsuperscript{44} Such a practice often tends to favour significant investors and analysts to discuss company performance,

\textsuperscript{39} This point will be clarified further when the conduct of dialogue is discussed in the next section.

\textsuperscript{40} The consequences of making an investor an insider will be discussed later in this chapter.

\textsuperscript{41} Such as if the company uses the Internet or other means, to ensure that all investors have access to the same information at the same time.


\textsuperscript{44} See, D. Bence, K. Hapeshi, and R. Hussey, supra, n 23; see also C. Marston, \textit{Investor Relations Meetings}, supra, n 2, at 88.
policies, etc. As mentioned in the introduction, this is called selective briefing, also known as private briefing. In broad terms, dialogue in the form of selective briefings is two-fold: namely, 'group meetings' and 'one-to-one meetings', both of which have evolved to answer the specific needs of the company or of investors.

According to Finch, almost all large public companies prepare sophisticated presentations for institutional shareholders that are delivered outside the formal meeting process. Such presentations are what other researchers call 'group meetings'. It is often the case that companies invite individuals from different organisations to attend. This would customarily take place immediately after companies' major announcements (i.e., half year and final results). Within these group meetings, such presentations would normally be delivered to investors by executive directors; particularly chief executive and finance directors; or investor relations' officers. Generally, the focus of discussion within the presentation is to explain, to those who are invited, the company's results, the reasoning behind them and comparing the company's performance to market indices, etc. Institutional investors and investment managers are also generally focused on acquiring information from such meetings to help understand the nature of the company's business.

The second form of dialogue is called a 'one-to-one meeting'. Either investors or companies call for such a meeting. The purpose of a one-to-one meeting is to discuss information of a specific and strategic nature, such as a takeover or merger. Hence, it would be attended by a small group of individuals from one institution or a small number of institutions. The 'meeting' could also take place over the phone.

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45 These terms are used interchangeably throughout the thesis.
47 It should be noted that calling 'conference calls' 'meetings' does not comply with the traditionally known and used meaning of the word. The word 'meeting', however, is used loosely in this chapter to include conference calls.

From a linguistic point of view, the most common definitions of the word 'meeting' are: '1 an assembly of people for a particular purpose, especially for formal discussion.... 2 an instance of two or more people meeting.' (See, *Concise Oxford Dictionary*, (Oxford University Press, 10th edn., Oxford, 1999))
Companies would usually offer one-to-one meetings to significant institutional shareholders or investment managers. These meetings would habitually take place twice a year, in-between announcements. Otherwise, companies would get trapped into discussing recent results, which they may rather prefer to undertake in group meetings.

From the above description of group and one-to-one meetings, it appears that the main difference between them is that the group meeting is habitually arranged to explain or justify already published results, while a one-to-one meeting customarily involves discussion of current and future corporate projects. Drawing on this difference between the group meeting and one-to-one meeting, this study embarked on exploring the basis and frequency of such meetings between institutional investors and investment managers with corporate managers. It was very important to establish a clearer picture of whether there is a good basis for methods institutional investors and investment managers can use to monitor corporate management.

In establishing the pattern and frequency of meetings to discuss corporate performance (i.e. a meeting that possesses the main characteristics of a group meeting) with corporate managers, both institutional investor and investment manager respondents were asked: on average, how often does your institution discuss corporate performance with the management of a company in which you hold shares? Table 6.2 (see Appendix I) shows the frequency with which institutional investors communicate with the management of companies (in which they hold shares), to discuss corporate performance.

Table 6.2 (see Appendix I) shows a low incidence of discussion about corporate performance between institutional investors and corporate management. Only 13.8%

48 See, National Investor Relations Institute, supra, n 2.
49 R. Barker, supra, n 2, at 8.
50 J. Holland, Corporate Communications with Institutional Shareholders, supra, n 2; and, 'Private Disclosure and Financial Reporting', supra, n 2.
51 It should be mentioned here that the results of the questionnaires are meant to provide indicative rather than conclusive evidence on what happens in practice.
of institutional investors hold discussions on a systematic basis of three, or six to twelve months. Less that 7% of institutional investors hold discussions on a three or six monthly basis. It is surprising that over two thirds of institutional shareholders do not hold any discussions about corporate performance with management at all. This might be partially due to the fact that a large number of institutional investors appear to delegate all the rights attached to their shares to their investment managers, presumably so that the institution can focus wholly on the performance of the investment. This can be supported by the comments on this question, which show that many institutional investors expect investment managers to hold dialogue with management. That is to say, some institutional investors simply perceive discussing corporate performance with corporate managers to be part of the job of investment managers, when they take on managing their investments.  

When the same question was asked to investment managers the results were almost the reverse. Table 6.3 (see Appendix I) shows that around two thirds of investment managers hold discussions with management about corporate performance on a systematic basis of either every six or twelve months. The stronger inclination towards discussion about corporate performance between investment managers and corporate management matches institutional investors’ expectations concerning a stronger level of discussion, than would be the case if they did not use external investment managers. Table 6.3 (See Appendix I) shows that almost 29% of investment managers do not have any dialogue with corporate managers and just over 64% have dialogue that takes place only every six to twelve months, while 7.1% have dialogue on an ad hoc basis. 

None of the investment manager respondents in this study have any dialogue with corporate managers, on a quarterly basis. This does not necessarily contradict Holland and Marston’s empirical research which indicated that corporations tend to hold a meeting, in the form of a group meeting or one-to-one meetings, every three months. In fact, the findings of the research conducted for this study complement Holland and Marston’s empirical research. The fact that corporations may hold four
meetings a year does not mean that every investment manager attends them. This is particularly so because significant institutional investors and investment managers typically attend one-to-one meetings, in one or a few companies only, and not all companies listed in the L.S.E., i.e. no investment manager or institutional shareholder has a significant stake in all of the L.S.E.'s companies.

Hence, the concern here relates more to group meetings which, although tend to be exclusive to market participants such as investment managers and institutional shareholders that meet certain criteria (normally related to the size of holding), are still attended by more investment managers and institutional shareholders than one-to-one meetings. It is not particularly surprising that an average investment manager does not meet with corporate management every three months. In fact, such a scenario might be viewed as rather a too 'cosy' relationship, unless there is an overwhelming interest on the part of that investment manager in the corporation. Of course, in certain cases, such as when a company is in trouble, investment managers may hold dialogue with corporate managers as frequently as every three months or more.

Investment managers and institutional investors were asked a more specific question about whether corporate management consults investment managers or shareholders with significant holdings of 3% or more to obtain prior consent for large transactions, such as an acquisition, which does not require shareholders' approval under the L.R. or the Companies Acts.\(^53\) This question was designed to examine the basis of one-to-one meetings, and gauge whether, based on the experience of the respondents, there was a correlation between the size of an investor’s stake and the likelihood of an invitation by corporate management to discuss corporate governance issues. Furthermore, it was hoped that this question would produce comments by institutional investors and investment managers that would give a better insight into what they think of such practices.

The results of this question were very interesting, even at the level of a substantial

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53 The threshold of 3% or more was chosen because this is the point at which s. 199 of the C.A. ’1985 treats shareholders as having a notifiable interest in a public company.
Part three Chapter Six

percentage holding, Table 6.4 (see Appendix I) shows that only 27.5% of institutional investors thought that approval would be sought, while 14.7% of them that such an approval would not be sought. The expectation was that a much higher percentage of respondents would agree that corporate management would seek approval from significant shareholders before large transactions. However, it may be that the results would have been different, as pointed out by a respondent, if the question had allowed for a response to the effect that 'There is consultation but not to obtain approval.'\textsuperscript{54} Another respondent remarked that: 'The company does not seek consent but explains to shareholders.'\textsuperscript{55} Such responses indicate that there is clearly scope for further research on the level and content of dialogue between institutions and management.

The same question was asked to investment managers and the results were extremely different. Table 6.5 (see Appendix I) illustrates that 57.1% thought that company managers do seek approval from investment managers. It is worth mentioning that none of the investment managers responded with 'no'. A comparison of Tables 6.4 and 6.5 suggests that the proportion of investment managers who think that there is consultation with holders of 3% shareholdings is more than double the figure than institutional shareholders who felt this to be the case. In the comments provided by investment managers, one investment manager was so specific as to state that it happens, 'occasionally maybe 15% of the time.'\textsuperscript{56} Another investment manager drew attention to the important role that the company stockbroker can play by stating that it is, 'usually [a] company's broker'\textsuperscript{57} who does this job. The latter investment manager's comment correlates with the work conducted by Marston,\textsuperscript{58} Holland\textsuperscript{59} and others, in that stockbrokers and financial

\textsuperscript{54} Institutional investors' questionnaire, control number 418.
\textsuperscript{55} Institutional investors' questionnaire, control number 433.
\textsuperscript{56} Investment managers' questionnaire, control number 121.
\textsuperscript{57} Investment managers' questionnaire, control number 231.
\textsuperscript{58} C. Marston, Investor Relations Meetings, supra, n 2; C. Marston, Investor Relations: Meetings the Analysts, supra, n 2; C. Marston, 'The Organisation of Investors Relations Functions', supra, n 2; and C. Marston, 'Company Communications', supra, n 2.
\textsuperscript{59} J. Holland, The Corporate Governance Role of Financial Institutions, supra, n 2; J. Holland, 'Private Disclosure and Financial Reporting', supra, n 2; J. Holland,
analysts are normally invited to attend one-to-one meetings, to discuss specific issues related to a company's future affairs.

In conclusion, according to this study, the frequency in which institutional investors hold discussions with corporate managers in the form of group meetings is rather low. This might be attributed to the fact that a great deal of institutional investors employ investment managers and therefore rely upon them to do this job on their behalf. Surprisingly however, although investment managers meet more frequently with corporate managers than institutional investors do, the frequency of meetings is still low, considering the fact that investment managers are relied upon to do this job.

6.4.3. 'Selective Briefing' versus Disclosure to the Whole Market

As discussed above, depending on the method of execution, dialogue potentially has great advantages to both companies and investors. Previous research, however, suggests that companies are selective in whom they choose to have dialogue with. Institutional investors and investment managers are definitely amongst the more favoured groups because of their size. In fact, it was reported that when private investors or even insignificant institutional shareholders ask companies that they invest in for more up-to-date information than the outdated management’s report, the reply is often: ‘that is sensitive information and cannot be provided.'\(^{61}\) The question then, is: what is the nature of the information disclosed to those significant shareholders and investment managers?

One might be inclined to believe that the answer to this question is that investment managers should not generally, seek to obtain price sensitive information. This is because price sensitive information would, unless other measures were put in place,

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\(^{60}\) For example, R. Barker, supra, n 2, at 3.

such as applying ‘Chinese Walls’, restrict institutional investors and investment managers’ ability to deal with shares. Furthermore, it is against chapter 9 of the L.R., which states that any price sensitive information should go first or simultaneously through the C.A.O. In fact, what investment managers and institutional investors should really aim to obtain, is soft information.

Soft information gives investment managers and institutional investors an edge over other market participants. Institutional investors and investment managers employ highly sophisticated financial analysts to monitor corporate managers, including taking part in dialogue with corporate managers which is a costly process. Hence, it was suggested that the sophistication and skills of such analysts and investors allow them to mix public information with unpublished soft information (i.e., information that is not price sensitive in its nature).

The practice of companies to favour significant shareholders, particularly institutional investors and investment managers, has caused a great deal of controversy. In reference to the argument for selective briefing, it can be delimited in the following lines of argument: First; it is often stated that companies could not, practically speaking, arrange to meet all investors to discuss company affairs, particularly in listed companies in which there are thousands of shareholders.

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62 ‘Chinese Walls’ is the expression used to refer to an information barrier within a firm which intended to ensure that information available to, or known by certain members of the firm is not available to other members of the firm. The origin of the expression is somewhat obscure and it seems that it became into common usage in the 1980s. It refers to the Great Wall of China by virtue of its’ impregnability. The issues related of ‘Chinese Walls’ and conflicts of interest are considered in more details in section 6.6.3.


64 The meaning of soft information together with the legal restrictions on dialogue is the subject of discussion in the next section.


Second; selective briefing as a form of disclosure decreases the volatility of share price. The claim here is that selective briefing (particularly to market analysts), helps them to make more accurate decisions about a company’s share price. Third; it is argued that other shareholders have the statutory right to express their opinion and voice their views in the company G.M. Fourth; some might argue that institutional investors and individual investors have the same interests anyway. Fifth; restricting informal relations between institutional investors and companies does not appear to be in harmony with the Government’s line of encouraging shareholders to make corporate managers more accountable. Sixth; it might be argued that early briefing of analysts on complex issues may be needed to give analysts in particular, the needed time to absorb and understand such information. Seventh; finally, it might even be argued that institutional investors should be rewarded for having dialogue with corporate management.

Thurber, an advocate for market control, not only promotes selective briefing, but also a form of insider dealing, as a solution to shareholders’ apathy in monitoring corporations and their managers. He argues that the existing insider dealing rules should be relaxed to allow monitoring contracts between companies and institutional shareholders. Under such contracts, institutional investors would agree to actively monitor the company in exchange for the right to purchase shares once they acquired good inside information from their position as insiders, monitoring the company management. Such a contract, Thurber argues, would encourage institutional shareholders to monitor corporate performance and corporate managers’ adequacy.

67 ibid.
68 The G.M. is the subject of discussion in chapter five of this thesis
69 See Higgs Report, supra, n 42, and Myners report, supra, n 43.
71 Although Thurber’s model might result in better monitoring, it is a very subjective way of rewarding investors. In addition, such a model might result in over-monitoring, bringing the company to a halt. Moreover, the model left important questions unanswered, such as: to whom such privileges should be given (i.e. institutional shareholders or their agents) and how would such information be communicated between institutional shareholders and their agents, investment managers? Would that be creating new directors duties for some shareholders? Even
With regards to the argument against selective briefing, it has been suggested that such favouritism is unfair and consequently damaging to market integrity and the reputation which it seeks to maintain and protect. Although there is wide agreement that dialogue between investors and managers might result in better performance, nonetheless every investor should have access to the same information at the same time. Furthermore, it is argued that the interests of institutional shareholders are different from the interests of individual shareholders. In addition, the argument that the early briefing of analysts on complex issues may be needed to give them the time to digest new information in order to reflect it in accurately pricing corporate shares, may be wholly inappropriate. This is because if the information is of such complexity that trained financial analysts need time to absorb and understand it, then anyone not present at the briefing will be greatly disadvantaged. In fact, some individual shareholders might be disadvantaged even when the information is disclosed to the whole market at the same time. This is because they might need a longer period of time than skilled investors to absorb, understand and react to it. Hence, although those analysts, privileged by an early view of the information, may be required to keep that information confidential until a general release can be made, their preparation might put them in a position to brief their sales force and clients as soon as the general release is made. Less privileged analysts and investors would have to however, wait until they have made sense of the public information before acting upon it.

In conclusion, one may argue that although dialogue in general can be greatly advantageous to both companies as well as shareholders, selective briefing fails on two accounts: market fairness; and, transparency. There should be no two-tier treatment of shareholders in the financial market. This is the basis for the current F.S.A. and Securities Exchange Commission (S.E.C.) position in forbidding selective briefing. So, how can the law ensure equality of the information received by all significant monitoring shareholders?

73 See for example, P. Coggan, and N. Cohen, ‘A Cautionary Culture: Philip Coggan and Norma Cohen on Performance Pressures Faced by Fund Managers’, (Financial Times, London, 3 June, 1995), 8. The issue of a conflict of interests is discussed further in section 6.6.3 of this chapter.
briefing. In addition, there is also no guarantee that selective briefing will only be restricted to soft, rather than price sensitive, information. As Mr Alistair Darling once said, '[t]he best weapon against insider dealing is openness.'74 In fact, there have been many allegations made that the main source for insider dealing is selective briefing. The next section attempts to distinguish between so-called soft information and the meaning of material 'inside information'.

6.5. The Basis of Dialogue: So-called ‘Soft Information’

There has been a great deal of speculation on the importance of soft information to institutional shareholders and investment managers. Coffee for example, states that:

[S]oft information is desired by institutions that trade actively in order to outperform the market—in effect by dumping shares if the information provided to it suggests a downturn in earnings that the market has not yet anticipated.75

It is easy enough to speculate about the importance of soft information. However, it is not clear what is meant by soft information as opposed to inside information. There is confusion about the meaning of soft information even amongst investors themselves in the U.K. This has been the case, particularly since the introduction of the F.S.M.A. 2000.76

In reading the above statement made by Coffee, one could deduce the following: first; that soft information is acquired from an insider source (i.e., company management or employee); and, second; it is also apparent that the reason for investors' interest in such information is that it is not yet published. Furthermore, the statements seem to suggest that the information would affect company share price. Such a description fits the case of inside information, which if traded upon would be a crime in the U.K. as well as on the other side of the Atlantic. However, such a claim is too simplistic and hence, an explanation of insider dealing and market abuse is needed in order to clarify the boundaries of soft information. It is the objective of

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the following title to provide elaboration on the meaning of soft information, by distinguishing between what falls into this category from insider dealing and market abuse. In addition, a brief discussion will be provided concerning the legal framework of dialogue between corporate managers and investors and investors inter se.

6.5.1. Legal Limitations of Dialogue between Investors and Corporate Management in the U.K.

The aim of the discussion under this title is to assess insider dealing and market abuse in order to clarify the boundaries of soft information and to investigate the alleged legal obstacles that affect investors’ ability to conduct dialogue with corporate management. It is claimed that shareholders could fear a situation in which they obtain ‘inside information’ which would inhibit them from dealing in shares due to insider dealing and market abuse rules. Hence, a short explanation is also offered on how the fear of becoming a ‘shadow director’ could affect shareholders’ (specifically significant shareholders) willingness to monitor and hold to account corporate managers. The next section under this title presents a discussion on insider dealing and how it affects dialogue.

6.5.1.1 Insider Dealing

Barry defines insider dealing as:

[...] trading on price sensitive information, by the company employees or others closely connected with the firm, which has not been disclosed to other market participants.

This definition addresses four elements in insider dealing: (a) the use of information; (b) which information is price sensitive; (c) not yet published information; and (d) by virtue of the insider position. Before elaborating on the meaning of insider

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77 I. Fazey, supra, n 72; See also, I. Owen, 'Parliament and Politics: Clarke to Hear the City on Insider Trading', (Financial Times, London, 15 April, 1993), 10.

dealing, this section offers a short introduction to the historical developments of the prohibition of insider dealing and the rationale behind doing so in the U.K.

### 6.5.1.1. The Historical Developments of Prohibiting Insider Dealing

Historically, directors could only have been pursued for a breach of fiduciary duties to the company rather than a criminal offence upon dealing, using privileged price sensitive information obtained from their position in the company. Insider dealing was mainly regulated and governed by regulatory organisations such as the Council for Stock Exchange and the Panel of Takeover and Mergers.\(^{79}\) Realising that there should be strict rules in order to crack down on insider dealing practices, several unsuccessful attempts were made in Britain to criminalize insider dealing, particularly, in the 1970s.\(^{80}\) However, it was not until the 1980 Companies Act that insider dealing became a criminal offence. The criminal offence of insider dealing was then re-enacted with minor amendments in the Company Securities (Insider Dealing) Act 1985. Immediately after, more minor amendments were introduced to the criminal offence of insider dealing by the Financial Services Act 1986.

In the 1980s and 1990s, the U.K. Conservative Government was under pressure from the Labour Party (in opposition at the time) to update insider dealing rules to overcome the problem of securing convictions. In highlighting their concerns, the Labour Party in 1988, analysed fifty of the largest takeover bids that took place in the L.S.E. after the 1987 market crash. They concluded in their report that there was strong reason for concern with regards to the presence of insider dealing. They alleged that as much as almost one third of all bids had strange unexplained share price movements, because of the heavy speculative trading, just before the intention

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\(^{79}\) Previously, the rules that organised insider dealing were: (a) not to make secret profit; and, (b) not to place oneself in a conflict of interests with the employer (the company). L. Denning for example, stated in the case of *Seager v Copydex* [1967] 2 All E.R. 415 at 417, that insiders should be prevented from taking advantage of their position in the company and should be held accountable for any profits made.

for takeover bids were announced.\textsuperscript{81} Newspapers reports, which often blamed selective briefing as the source that frequently left insider dealing undetected, placed even more pressure on the Government to toughen its stance against insider dealing. This allegation was based on the assumption that price sensitive information might be leaked during those private or selective briefings, highlighted in some cases by sharp rises in share trading, prior to important corporate announcements.\textsuperscript{82}

The mixture of pressure from lobbying parliamentary groups and the complexity of the Financial Services Act (1986), which made it very hard to secure a conviction, finally led the Government in 1989 to agree to the E.C. Directive, entitled ‘Coordinating Regulations on Insider Dealing.’\textsuperscript{83} The U.K. Government also redrafted the Financial Services Act 1986, resulting in the insider dealing provisions that are found in Paragraph V of the Criminal Justice Act 1993 (C.J.A. 1993, hereafter). This consequently led to a major shift in pursuing insider dealing. As is the case today, liability no longer has to be based purely on having received information as a result of a breach of fiduciary duty.\textsuperscript{84} Liability under the C.J.A. 1993 is based merely on whether the offender knows that he/she has inside information, regardless to how this information was acquired.\textsuperscript{85} This expansion goes wider than Barry’s definition of insider dealing.

The methods of detecting insider dealing are mainly: (a) receiving a tip from an informant; (b) detection by the Integrated Monitoring and Surveillance System (I.M.S.S. hereafter) and the Intelligence Alert System (I.A.S. hereafter),\textsuperscript{86} which

\begin{flushleft}

\textsuperscript{82} ‘Private briefing’ and its alleged relation with insider dealing are discussed in more details later in this chapter.

\textsuperscript{83} Council Directive 89/592 EEC.


\end{flushleft}
were put in place to support the crack down on insider dealing. For example, after the I.M.S.S. detected a high surge in trading in Portals (the banknote paper maker) in December 1994, the L.S.E. asked Portals brokers if Portals was involved in any transaction which could explain the share surge and if so, wanted Portals to put out a statement. Portals did put out a statement (50 minutes after the detection had been made), declaring that it was in talks with De La Rue, (the banker printer), about increasing common links between the two companies. After this introduction to the historical developments of the prohibition of insider dealing prior to the C.J.A. 1993, the next subject of discussion is the rationale behind prohibiting insider dealing.

6.5.1.1.2. The Rationale for Prohibiting Insider Dealing

In discussing the legislature's rationale for prohibiting insider dealing, it is important to examine whether or not such a prohibition affects shareholders' ability to monitor corporations and their managers and hold them to account. There is also the question of whether the practices that take place in the market, particularly selective briefing, correspond with that rationale.

One of the most important pillars in a capital market is information that is efficient, up-to-date and reliable. Such information should lead to accurate share prices that represent true value. The normal channel of obtaining information is through a company's reports and other public documents. In keeping the U.K. market informed, listed companies have to disclose price sensitive information without delay. Nonetheless, it is sometimes necessary for the prosperity of a given company to delay the disclosure of price sensitive information. For example, it might be the case that when a company has made a new discovery or invention,

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87 See, R. Peston, 'Stock Exchange Steps Up Insider Dealing Rules', (Financial Times, London, 8 December, 1994), 8. Portals is an extraordinary case from the 1990s. Share price in Portals soared from 44p to 679p before the announcement was finally made that De La Rue had approached Portals.

Of course, the Stock Exchange has the power to halt trading in individual companies’ shares if there is evidence that price sensitive information has leaked. Companies would be moved temporally from the electronic trading screen.

88 See the discussion in Chapter 9 of the L.R., earlier in this chapter.

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there is a desire to examine its viability before disclosing the news to the market.\textsuperscript{89} This gives an insider the position of having inside privileged information.

Criminalizing insider dealing originally aimed to crack down on profit making or the avoidance of loss by insiders just before important company announcements. The motive for prohibiting insider dealing was also to keep public confidence in the market. For example, L.J. Lane in the case of \textit{Attorney General's Reference (No. 1 of 1988)}\textsuperscript{90} stated that the reason behind the prohibition of insider dealing was:

\begin{quote}
The obvious and understandable concern ... about the damage to public confidence which insider dealing is likely to cause and the clear intention to prevent so far as possible what amounts to cheating when those with inside knowledge use that knowledge to make profit in dealing with others.
\end{quote}

As in L.J. Lane's statement, maintaining market integrity was another reason for prohibiting insider dealing.\textsuperscript{91} According to the D.T.I. 1973 White Paper on Company Law Reform,\textsuperscript{92} the maintenance of market integrity requires that all investors should have equal access to company information that would affect shareholders' decisions on dealing with company shares. Once the information is made public, investors will have the 'same chance'\textsuperscript{93} to examine and analyse the information and trade in its shares accordingly. Asymmetric information can result in a serious inequality in risk bearing among investors. This is because those investors who possess privileged information would take a much lower risk when dealing with the company’s shares, compared to investors who had no access to the

\textsuperscript{89} It is understandable though that those companies might choose not to disclose information for strategic reasons (although this does not justify an insider who uses inside information for personal gains). See the discussion earlier in this chapter.

\textsuperscript{90} [1989] 1 A.C. 971. H.L.

\textsuperscript{91} Market legislations, reports or EC directives, frequently mention the maintenance of the integrity of the market. This is evident in Para. 9.34 of the Gower Report, (see, L. Bower, Review of Investors Protection (1984) \textit{Cmnd. 9125}). Maintaining market integrity was also mentioned in the Preamble of the European Community Insider Dealing Directive, (89/592 1989, O.J L334/30).

\textsuperscript{92} \textit{Cmnd.} 5391, para. 15.

\textsuperscript{93} The author realises that the use of the phrases 'same chance to information' and 'equality of information' may not be accurate. However, they are used here to refer to that information which is made available by the issuer to the whole market at the same time.
same information.94 Thus, allowing insider dealing would discourage insiders from disclosing company information. ‘Equality’ of information and disclosure of material information in a timely manner would result in an efficient market (i.e. the market would mirror the correct value or the company’s shares).

Despite the fact that there is agreement that insider dealing is morally unacceptable, some economists argue that it should not be regulated. They perceive insider dealing as a victimless act, arguing that prohibiting, rather than allowing insider dealing, harms market efficiency.95 This line of reasoning assumes that allowing insider dealing actually brings price sensitive information to the market quicker.96 According to those economists, in an efficient market, once information is released, it will be incorporated into share prices rapidly and rationally, which would result in the market reflecting the unbiased and true value of the shares.97 Wu, for instance, states that insiders are speculators who play an economically important role in stabilising prices.98 Such a view suggests that one can deduce the company’s performance from insiders’ trading behaviour.99 This is called ‘copycat dealing’, which would allegedly move shares price towards the ‘right value’.100

Furthermore, it is envisaged by some economists, such as Mann, that insider dealing can be used as a compensation device for corporate managers.101 It is argued that using insider dealing as a compensation device in the form of bonuses or salaries would not affect the market anyway, because management would be rewarded for their good performance. Allowing insider dealing would also lead to discoverers and

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100 For more details on ‘copycat dealing’ see below.
101 H. Mann, supra, n 98.
innovators benefiting from their discoveries and innovations. The American case of Securities Exchange Commission v Texas Gulf of Sulphur is often quoted to support the argument for insider dealing.

In refuting the above lines of argument that make a case for allowing insider dealing, one can disagree in the first instance with the suggestion that one can deduce company performance from insiders' behaviour in trading - 'copycat dealing'. Such a claim is too simplistic. Although, share purchases are generally more significant than shares sales, one can not rely on management dealing in securities of the companies that they manage, to give an indication of what is going on inside the company. There are many reasons for directors to sell shares on the other

102 H. Mann, supra, n 98; see also H. Mann, supra, n 95, at 129.


104 The facts of this case were that Texas Gulf of Sulphur, a company that produces sulphur, was interested in expanding its business to explore for minerals in Canada. As a result, Texas Gulf of Sulphur, formed a team of five people consisting of mainly specialists, to explore an area in Eastern Canada. The Ariel survey in 1959, showed various anomalies in the geological structure of that area which is an indication for minerals. A ground survey to the area followed in 1963, which confirmed the existence of zinc and copper in the rock formation of the area. Therefore, the executive of the team ordered that more land to be acquired while keeping the drilling confidential. Meanwhile, the team stared buying shares in the company. More land was acquired and the drilling resumed. When the information was made public the share price climbed up sharply. The Securities Exchange Commission brought an insider dealing action against the team members. The court held that those insiders who are in possession of price sensitive information must either disclose it to the public or abstain themselves from dealing with the shares, if making the information public is not in to the best interests of the company.

105 Following the example of the U.S., it is becoming common in the U.K. to track company directors' share dealings. For example, it the practice that the Financial Times regularly gives details of all the latest directors' dealings in the Weekend section. See, G. O'Connor, 'Financial Times Guide for the Securities Investors (9): Keep an Ear to the Boardroom Door – Directors' Dealings / A Look at the Legal Way of Getting What Amounts to an Inside Tip from Those in the Know – the People Who Run the Company', (Financial Times, London, 17 September, 1994), 14.

106 This is because directors, as any other investors, are not going to buy shares if they think that their value is going to decrease in the near future.

107 Empirical research is inconclusive in finding evidence to suggest a positive correlation between company insider(s), dealing in company shares, and price movements. In fact, there is conflicting evidence on the effects of insider(s)' trading on share price. On one hand, Meullbrook suggests such a relation (L. Meullbrook, 'An Empirical Analysis of Illegal Insider Trading', (1992) 47, Journal of Finance, at
hand. Among those reasons is the need to release an investment in the shares, to allow personal expenditure or to take advantage of a new investment opportunity.\textsuperscript{108} Furthermore, when it comes to announcements of company performance, directors are governed by the ‘catchall’ rule, that directors may not deal when in possession of unpublished price sensitive information. Hence, for a director, buying shortly before his/her company had acquired an important order, would be objectionable. Hence, directors can only trade in shares legally if they have a long-term vision of the direction of the company.

Second, the use of insider dealing as a compensation device is highly subjective. Hence, it would be hard to promote such an idea, not only to market participants but also to corporate managers themselves. In addition, inventors and discoverers are normally paid agents of the company who are obliged to honour fiduciary duties in executing their work, including the duty not to make secret profit and not to place themselves in a conflict of interests with their principal (the company). Inventors and discoverers are not normally the beneficiaries of insider dealing anyway. If compensating inventors and discoverers is the issue, then one can argue that that law of contract can be used to solve such a problem. The law of contract can be used here to provide better protection to inventors and discoverers’ interests in their employment contract. For example, a term can be added to the employment contract of inventors and discoverers for them to benefit directly from what they invent or discover, perhaps through a share of the profit made by the company from those discoveries and inventions.\textsuperscript{109} Hence, it is rather absurd to use the argument that insider dealing should be legitimised in order for inventors and discoverers to benefit from their discoveries and innovations.

\textsuperscript{1661} On the other hand, Chakravarty and McConnell, suggest that there is no such correlation (S. Chakravarty, and J. McConnell, ‘Does Insider Trading really Move Stock Price? Paper No 1114’, (Krannert Graduate School of Management, Purdue University)).

\textsuperscript{108} Having said that, one must assert that there have been many examples in the past where the selling of shares by directors gave indication to how a given company was performing. For example, when Alan Sugar sold £35 million of Amstrad shares (as a company director at the time) in March 1991, claiming that he needed the money for some property investments, four months later the company shares lost half of their value. See, G. O’Connor, supra, n 105.

In refuting the claim that insider dealing is a victimless crime, one may argue that not only does market integrity, credibility, and efficiency suffer from insider dealing practices, but so do counter parties in trading, due to the insider having an information advantage. One can argue that there is in fact a victim with a credible claim, which is recognised by some jurisdictions, as the investor that invests on the base of serious asymmetric information. Furthermore, the market and its credibility is another very credible victim. Hence, there have been voices calling for civil actions to replace or to be parallel with criminal proceedings related to insider dealing. The call for civil action was finally acknowledged in the F.S.M.A. 2000. Section 118 of the F.S.M.A. 2000 in particular, introduced a net of civil penalties for market abuses, including the misuse of insider information, which complement rather than replace the right of the F.S.A. to bring about criminal proceedings. The civil sanctions that were introduced by the F.S.M.A. 2000 and the relevant F.S.A. powers are discussed later on in this chapter.

After introducing both the historical developments of prohibiting insider dealing, as well as some of the arguments surrounding insider dealing, the crime of insider dealing is the next subject of discussion. As mentioned earlier, distinguishing the boundaries of material price sensitive information in offences of insider dealing and market abuse, helps to identify what soft information actually is, i.e. that information which would not lead to insider dealing and market abuse, may be considered as soft information. Since a definition of insider dealing was provided earlier in this chapter, the meaning of ‘insiders’ is the next subject of discussion.

110 In South Africa, for example, the Insider Trading Act 1998, distributes the recovered amounts from an insider to the investors who traded contemporaneously with the insider. See, S. Widder, ‘South Africa Insider Trading Regulation’, (2002) 23 (6), Company Lawyer, 191.

According to the C.J.A. 1993, insiders can be divided into two types: primary and secondary. A primary insider may be defined as: an individual who possesses; because of her/his position in the company; price sensitive information and deals with the company’s shares, relying on that information. The C.J.A., 1993 provides a wide definition to the meaning of primary insiders. Section 57(2)(a) states that a primary insider can be a director, an employee, a shareholder, and anyone who holds inside information by virtue of his position in the company. Section 57(2)(a) bases the definition of insiders on the fact that they have obtained price sensitive information directly from the company. Such a definition is wide enough to include for example, the other party in a transaction with the company, if the disclosure of such a transaction would affect the share price of the company.

The second type of insider is the secondary insider, also legally known as a ‘tippee’, which may be defined as: any individual other than the primary insiders who has inside information from a primary insider, or from a source that can be traced to a primary insider. The prerequisites for the second type of insider are: first, that the tippee must know that the information came from a connected person; second, for the insider to know or reasonably believe that the information has come by virtue of

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112 The word ‘individuals’, rather than the usual legal word ‘persons’, is intentionally used by the Act, making insider dealing a crime that is only applicable to people, rather that legal entities, such as companies or institutional shareholders (for example, pension funds or insurance companies). The reason for such exclusion might be to prevent individuals from using the legal term ‘persons’, as a shield to escape prosecution.

113 Since the 1993 C.J.A., it is an offence to deal with securities or encourage another to do so when is possession of inside information, or to disclose inside information, or to disclose inside information other than in the proper performance of the job. In fact, even before the 1993 C.J.A., this was arguably the case. For example, in May 1992, Mr Thorold Mackie, a Scottish investment analyst who worked for the Edinburgh stockbrokers ‘Bell Lawrie White’, was convicted of insider dealing on advising clients to sell their shares in the waste disposal company (Shanks McEwan), after being told by its Chairman (Peter Runciman) that things were not going well at the company. See, ‘Mackie (Thorold) v HM Advocates’, (1995) S.L.T. 110, 1994 SCCR 277; see also, R. Rice, ‘Business and Law: Analysts Wary of Tighter Net –Robert Rice Looks at the Impact of Expanded insider Dealing Regulation’, (Financial Times, London, 22 March, 1994), 16. The Court of Criminal Appeal in Edinburgh quashed the conviction in 1994, on the basis that the trial judge had misdirected the jury. For more details see, J. Buxton, and D. Wighton, ‘Acquittal Ruling Fails to Ease Wariness in City’, (Financial Times, London, 18 February, 1994), 10.

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connection with the company; and third, that the tippee must know or reasonably believe that the information should not be disclosed to them except through the appropriate channel of disclosure. However, it is rather difficult to satisfy these three prerequisites. In *R v Kettle and Thorneywor*114 for example, the defendant was cleared of insider dealing because of the prosecutions’ failure to produce evidence to show that the defendant knew that the information was confidential.

It seems, at least technically, that the language used in the section suggests that if the information was acquired from an outsider unconnected to the company, using the information would not be prohibited. The C.J.A. 1993 requires that the prosecution must establish that the alleged offender was aware that she or he had obtained inside information.115 In order to satisfy this requirement, a person must have obtained inside information that was received from an insider source.116 The problem with such a requirement is that it is difficult to prove the link with the company, particularly when the alleged offender has acquired the information after it was passed down from the original insider through a chain of stratums of sub-insiders. This was said to be one of the main reasons for the low number of prosecutions against suspected insider dealing.117 Furthermore, s. 57(2)(a) limits insiders to directors, employees, shareholders, and anyone who holds inside information by virtue of his position in the company.118 Hence, one can argue that, at least

114 Unreported case (noted in (1985) 6, *Company Lawyer*, at 97). The facts of this case were that two employees of a firm obtained information from a stock-broking firm that were dealing with Blockleys Plc, which made them believe that a third party was going to acquire a considerable number of Blockleys Plc shares to launch a takeover bid. They therefore, bought shares in Blockleys Plc with the hope of a better share price when the takeover began.

115 See, s. 52(1) C.J.A. 1993.

116 See, s. 56 & 57(1) C.J.A. 1993.


118 Section 57 of the C.J.A. 1993 states in the meaning of ‘Insiders’:

(1) For the purposes of this Part, a person has information as an insider if and only if—

(a) it is, and he knows that it is, inside information, and

(b) he has it, and knows that he has it, from an inside source.

(2) For the purposes of subs. (1), a person has information from an inside source if and only if—
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technically, one would be outside the boundaries of insider dealing, if one dealt with price sensitive information that was acquired from the bins outside the company building.\footnote{119}

6.5.1.1.4. Inside Information

Inside information can be described as the most important element of insider dealing. Mere knowledge of unpublished price sensitive information, in most cases, would automatically subject the individual to insider dealing regulations, i.e., not being able to trade in the securities of that company. As mentioned earlier, the failure of previous legislation to secure convictions and the incoming reports and pressure of the opposition party (the Labour Party at the time), pressed the Government to adopt the E.C. Directive and later draft new legislation against insider dealing, which is now Part V of the 1993 C.J.A. Companies’ practices of private or selective briefing, were thought to be the main cause for insider dealing. Arguably, the main aim of the C.J.A. 1993 insider dealing legislation was to ensure ‘equality’ of information. When the C.J.A. 1993 was enacted, it defined insider dealing in s. 56(1) as follows:

\begin{quote}
inside information' means information which--
\begin{enumerate}
\item relates to particular securities or to a particular issuer of securities or to particular issuers of securities and not to securities generally or to issuers of securities generally;
\item is specific or precise;
\item has not been made public; and
\item if it were made public would be likely to have a significant effect on the price of any securities.
\end{enumerate}
\end{quote}

Hence, information must be yet unpublished and price sensitive information. The issue of publicity of information was clarified in s. 58 that states in subsection (2) that information is made public, ‘if it is published in accordance with the rules of a regulated market for the purpose of informing investors and their professional

\begin{quote}
\begin{enumerate}
\item he has it through--
\begin{enumerate}
\item being a director, employee or shareholder of an issuer of securities; or
\item having access to the information by virtue of his employment, office or profession; or
\end{enumerate}
\item the direct or indirect source of his information is a person within paragraph (a).
\end{enumerate}
\end{quote}

\footnote{119}{See, L. Linklater, supra, n 80, at 467.}

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advisors'. Thus, under the C.J.A. 1993, information can be considered ‘made public’ if it was made accessible to an unlimited number of the markets’ participants. For example, information is ‘made public’ if it is published in a record that is open for public inspection.\(^{120}\) On the other hand, a publication that is made during the A.G.M., is not public information since it is only limited to the company’s members, rather than the whole market. In addition, the quotation above requires that information should be precise or specific in order to satisfy the definition of inside information. This necessarily means that rumours, mere opinion or, assumptions could not be considered as inside information, even if it affects the securities price.

Sections 56 & 57(1) C.J.A. 1993 further require that information must come by virtue of a connection with the company and that it would be reasonable to expect from a person who is connected to the company not to disclose inside information to a third party, apart from through the proper conduct of disclosure. It is apparent that the law here seems to apply an objective test on the company insider. It has to be noted that C.J.A. 1993 falls short of achieving its aim of ‘equality’ of information. The publication of information in an electronic system such as Reuters or Bloomberg is suffice enough to be considered as ‘made public’, even though such services are not generally made available to the average investor.\(^{121}\) This seems to limit some investors’ ability, particularly private investors, to the ‘same access of information’. Section 58(3) of the C.J.A. 1993, for example states that information may be treated as ‘made public’ even though:

(a) it can be acquired only by persons exercising diligence or expertise;
(b) it is communicated to a section of the public and not to the public at large;
(c) it can be acquired only by observation;
(d) it is communicated only on payment of a fee; or
(e) it is published only outside the United Kingdom.

The C.J.A. 1993 left it to the courts to develop guidelines in deciding whether information has an effect on securities prices or not. Although it seems that the law applies an objective test on whether the information is price sensitive or not, such a test favours skilled investors, particularly institutional investors, while disadvantaging some private investors. This is because skilled investors might be

\(^{120}\) Section 58(2)(b).

\(^{121}\) S. Widder, supra, n 110, at 192.
able to link disclosed information with some insignificant non-public information to make a business judgment about his/her shares in the company, which other reasonable investors might find hard to deduce. The U.S. courts, however, seem to apply a dual test which is both subjective and objective, in deciding whether the information has an effect on securities price or not. The American Supreme Court, for example, held in the Basic Inc. v Levinson\(^{122}\) that information would be price sensitive information if there was a substantial likelihood that such a disclosure would be viewed by a reasonable investor as having significantly altered the 'total mix' of information made available. The sophistication of some investors in analysing information was also realised by the American Second Circuit in the case of Elkind v Liggett & Myers, Inc.,\(^{123}\) which held:

a skilled analyst with knowledge of the company and industry may piece seemingly inconsequential [non-public] data together with public information into a mosaic which [viewed as a whole] reveals material non-public information.

Though not to the credit of those who are against insider dealing, it is true that in the absence of clear insider dealing rules, investors might deprive themselves of valuable information, fearing that it might be inside information. For example, Alcock reported that the vague insider dealing legislation discourages dialogue between investors and companies.\(^{124}\) Also, criminal proceedings are thought to be 'a powerful but necessarily blunt instrument.'\(^{125}\) This is because of the rigorous demand of proof in criminal law, which requires proving the case beyond reasonable doubt, as opposed to civil action where the case would be decided in the balance of probabilities.\(^{126}\) For example, from about 180 cases that were brought to the prosecution services by the Stock Exchange between 1980 and April of 1994, there

\(^{122}\) 85 U.S. 224 (1988).

\(^{123}\) 35 F.2d 156 (2d Cir. 1980).

\(^{124}\) A. Alcock, supra, n 65.

\(^{125}\) See, J. Eadie, supra, n 119.

were only 26 prosecutions, which resulted in only 10 convictions. This led the L.S.E. to issue a consultation paper in October 1994, suggesting the suspension of trading in companies where there was evidence that price sensitive information was being leaked.

A more recent example is Logica (the management and IT consultancy services provider). It was reported that the daily trading volume over the six months ending just a few days before an important announcement averaged at 7.6m shares a day. Two days before the announcement, 11.4m shares changed hands, and on the following day 27.2m, according to datastream statistics. On the day after the announcement, the company duly issued a profits warning. Chubb (the security and fire extinguisher company) is another example where the average daily turnover is around 1m shares, but six days prior to a bid announcement trading surged to 4.9m a day.

It would be inaccurate to say that all irregular unexplained share movements can be accredited to insider dealing. There could be a number of reasons for these strange movements in share price, such as market trends and speculations. For example, in the mid 1990's, it became a strong market trend to invest in Dotcom companies, which led to sudden sharp increases in those companies' shares. However, at the end of the 1990's, it became the trend to get rid of Dotcom companies' shares, due to the

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127 N. Barry, supra, n 80, at 38. For more details see; The Financial Times Report, ‘Crackdown on Criminal Trading: A Click on the Mouse is all it Takes to Track the Shares Riders’, (Financial Times, London, 3 October, 1994), 11.

speculation that they were seriously overvalued, which led to the crash of many of those companies. It is probably fair to say though, that insider dealing was one of the reasons for the end of many of those companies. It is difficult though to assess the role of insider dealing in these price movements. After all, one has to prove that a ‘crime’ has taken place.

Market researchers and analysts using both, significant published information and soft (not price sensitive) unpublished information, can sometimes predict movements in the market. It is also fairly easy to predict that under performing companies can be targeted by companies that are doing well in the same sector, for example. Furthermore, it is very hard to conceal sudden movements from one company approaching another troubled company, as such sudden movements would no doubt prompt rumours about the possibility of a takeover.

In conclusion, the definition of inside information is very restricted. Four tough prerequisites are required in order to satisfy what actually constitutes insider information. The first two prerequisites come directly from s. 57(1) of the C.J.A. 1993 (quoted above). These two prerequisites are that: first, the information must be yet unpublished and price sensitive information; and second that information should be precise or specific in order to satisfy inside information. The third prerequisite which is deduced from ss. 56 & 57(1) C.J.A. 1993 is that information must come by virtue of a connection with the company; and the fourth prerequisite is that it would be reasonable to expect from a person who is connected to the company, not to disclose inside information to a third party, apart from through the proper conduct of disclosure.

In spite the fact that arguably that the vagueness in the insider dealing regulations driven some investors to avoid dialogue with corporate managers fearing being accused of dealing upon possessing inside information, yet restricting the application of insider dealing did leave room for some corporate managers to hold dialogue with some shareholders in the form of private briefings. Of course, if restricting the meaning of insider information left wide scope for dialogue between some corporate managers and some shareholders, it has also left the door open for
inside information to be passed to some of those shareholders if they agree not to trade in company shares. This has resulted in a great deal of difficulty in securing convictions against alleged insider traders and moreover, that the C.J.A. 1993, did not achieve its aim of fairness. Significant shareholders, particularly significant institutional shareholders and investment managers, are often treated more favourably than other shareholders. This is done much of the time by using the issue of practicality as an excuse (i.e., that it is not practical for companies to invite all shareholders and market participant to company news briefings), when in some cases, the real issue concerns 'buying' significant shareholders' satisfaction.

While one can agree that it is beneficial to involve significant shareholders in corporate governance issues, it is difficult to approve that the door be shut in the faces of other shareholders who wish to be involved in corporate governance. Nor is it the case that there is evidence that the problem of agency cost would disappear if significant shareholders and their managers were given the authority to monitor our corporations. Furthermore, the two-tier treatment of shareholders should not have a place in a modern market that enjoys a developed means of communication. Such factors have made the case for modernising the financial market laws and regulations. The financial market laws and regulations, beginning with the F.S.M.A. 2000, and their consequences on dialogue between corporate managers and shareholders, are the subject of discussion under the next title.

6.5.2. The F.S.M.A. 2000

Insider dealing rules have clearly proved unsuccessful in protecting the market's integrity. The Labour Party included in its 1993 and 1997 election manifestos that it intended to introduce major changes that would help to restore public confidence in the financial market. Upon taking the reins of power in 1997, the Labour Party finally found the opportunity to overhaul the market regulations, resulting in the F.S.M.A. 2000. The F.S.M.A. 2000 brought new rules to the market, which complements Part V of C.J.A. 1993, rather than replacing it. Part V of the C.J.A. 1993 is still a primary source in tackling and fighting insider dealing.
This study is particularly concerned with two of the changes introduced by the F.S.M.A. 2000, namely; the introduction of civil liability to fight the misuse of information; and, the F.S.A. as the sole market regulator, that has overall responsibility for the investigation and prosecution of market abuse offences and misuse of information.\textsuperscript{129} Having a single central regulator is thought to overcome the duplication and confusion that existed under the previous Financial Services Act 1986, where a number of organisations were in charge of the market. This is also thought to have created clearer and better accountability to the government.\textsuperscript{130} The implemented changes that gave the F.S.A. the overall power in controlling the market and the nature of those powers are the subject matter of discussion under the next title

6.5.2.1. The Financial Services Authority (F.S.A.)

The F.S.A. is the only appointed regulator under the F.S.M.A. for the whole financial services industry. It is responsible for supervising banks, building societies, friendly societies, insurance companies and other financial institutions. In doing so, it takes over the roles previously exercised by institutions such as: the Supervision and Surveillance Department of the Bank of England; the Investment Management Regulatory Organisation (I.M.R.O.); the Personal Investment Authority (P.I.A.); Securities and Futures Authority (S.F.A.); the Insurance Directorate of the Department of Trade and Industry; the Building Societies Commission; the Friendly Societies Commission; and, the Register of Friendly Societies. The F.S.A. has also recently acquired further responsibilities for regulating mortgage advice and insurance intermediaries and supervising credit unions. All of these roles are in addition to the responsibilities previously taken over by the F.S.A., such as being the competent authority for listing in the U.K. (the U.K.L.A) and the supervision of banks.

\textsuperscript{129} See, s. 402 of the F.S.M.A. 2000. The reason for establishing the F.S.A. was that the government believed that having a single central regulator as influenced by the U.S. example, (i.e., the Security Exchange Commission (S.E.C.)) would entail that fragmented organisations would respond better in a dynamic market.

\textsuperscript{130} See, M. Dickson, 'The Clock is Ticking as Ground Force Meets the City: There Are Just Seven Months Remaining Until the Financial Services Authority Assumes its Full Powers and the Deadline is Causing Anxiety Among Many Firms', (Financial Times, London, 5 May, 2001), 13.

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The F.S.A. commenced its full power to give ‘unlimited fines’ on 1 December 2001. The F.S.A. is under a duty to act in such a way that is compatible with, and appropriate to meet, the objectives listed in the F.S.M.A. which are: maintaining market confidence in the financial system; promoting public understanding of the financial system; protecting consumers; and, reducing financial crime. In achieving these set objectives, the F.S.A. must consider the principles of good regulation, such as: using resources in the most economic and efficient way; the responsibilities of those who manage the affairs of authorised persons; being proportionate in imposing burdens or restrictions on the industry; facilitating innovation; taking into account the international character of financial services and the U.K.’s competitive position; and, not impeding or distorting competition unnecessarily.

Since the F.S.A. has extensive powers to execute its new role, as the one and only market regulator, the F.S.M.A. holds a number of regulatory devices and safeguards to make sure that the F.S.A. is accountable for its actions, which for example, include: (1) the Complaints Scheme to deal with complaints made against the F.S.A. in its exercise of functions other than legislative functions, and that consists of allegations of negligence, mistake, lack of care, unreasonable delay, unprofessional behaviour, bias and lack of integrity; (2) independent inquiries will be held into matters which are or could be ‘a grave risk to the financial system’ or which caused or risk causing ‘significant damage to the interests of consumers’; (3) restrictions on the F.S.A. immunity, i.e. although the F.S.A. generally has immunity from civil actions, this immunity will be waived if the F.S.A. has acted in bad faith or in a

131 A. Alcock, supra, n 65, at 142.

132 Upon the proposal for the new F.S.A. powers, the F.S.A. was criticised for having extensive powers, acting in some cases as judge and jury when enforcing disciplinary procedures, yet lacking accountability. For example, Angela Knight (chief executive of the Association of Private Client Investment Managers and Stockbrokers) said in 1998: ‘As proposed the FSA is both judge and jury for firms and unaccountable to the regulated community who pay for it’. Peter Smith (senior partner at PricewaterhouseCooper, the accountancy firm) went further to say: ‘... there is a considerable amount of power in the hands of the F.S.A., which results in being policeman, prosecutor, judge, jury and gaoler.’ Both statements were taken from G. Graham, ‘Britain: Watchdog Demands End to Interim Role: Financial Regulation Call Comes Amid Sector’s Criticism of Proposed Powers’, (Financial Times, London, 30 October, 1998), 10.

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manner incompatible with the European Convention on Human Rights (section 6(1) Human Rights Act 1998);¹³³ and, the F.S.A. is required to set up these bodies such as the Financial Services Practitioner Panel and the Financial Services Consumer Panel that help to ensure an open and transparent approach to policy making, as part of its general duty to consult practitioners and consumers in making sure that policies of the F.S.A. are working in coherence with the F.S.A.’s objectives and principles of good regulation.

The F.S.A. has been invested with considerable powers to punish market abuse. Not only is the F.S.A. now the only market regulator including being the U.K.L.A., but also, the F.S.A. in its capacity as the U.K.L.A now has the power to pursue any alleged breaches of the L.R. and the alleged offences of insider dealing and market abuse. Moreover, the F.S.A. has the power to place ‘unlimited’ fines on those who commit such offences. This is extensively different to the old and weak position of the U.K.L.A in pursuing breaches of the L.R. Giving all power to the F.S.A. in pursing breaches of the L.R., insider dealing and market abuse, will no doubt help to overcome the communication problems that normally arise when different agencies deal with such matters. Punishments for market abuse include: the imposition of an unlimited financial penalty by the F.S.A.; publication of a statement by the F.S.A that a person has engaged in market abuse; an injunction granted by the High Court; and, a restitution order made by the High Court on the application of the F.S.A.

After an introduction to the changes that occurred to the F.S.A. in its capacity as the U.K.L.A, the second change that occurred to the financial market (i.e. the introduction of the market abuse offence) is now the subject matter of the next title. The particular concern of this title is the offence of market abuse and its consequences on dialogue between corporate managers and shareholders.

6.5.2.2. Market Abuse

Alcock defines market abuse (based on s. 118 of the F.S.M.A. 2000) as:¹³⁴

behaviour (action or inaction) anywhere in the world, directly or indirectly affecting investments traded on a U.K. market:
that is likely to be regarded by regular users of the market as falling below the standard reasonably expected of a person in that position; and
which is at least one of three types:
based on information which is not generally available the market but which likely to be regarded by a regular user as relevant in deciding the terms on which to deal in such investments (i.e. insider dealing);
likely to give a regular user a false or misleading impression as to the market or value of such investments (i.e. misleading statements and practices);
regarded by a regular user as likely to, distort the market in such investments (i.e. rigging the market).

In other words, market abuse is an action or inaction that is based on information not generally available to other market participants, and that a regular user of the market he/she would or would be likely to consider it as relevant in affecting the price of investment. In addition, the F.S.M.A. 2000 does not require proof of intent, recklessness or actual knowledge in the offender of market abuse.

The crime of market abuse consists of behaviour which occurs in relation to qualifying investments, which include not only shares and bonds, but also certain derivatives ‘traded on’ a prescribed market, which a regular user of that market would consider as amounting to a failure to observe the ‘standard of behaviour’ that is ‘reasonably’ expected of a person in his or their position in relation to the market. As mentioned in Alcock’s definition (above), the ‘standard of behaviour’, in principle, includes not only action but also inaction. Hence, if a company fails to make a particular disclosure which it is under a legal or regulatory obligation to make (e.g., under the L.R.), it might in principle, have committed market abuse. This means that those persons who not only deal, but also arrange deals, manage investments, cause or procure, or advise others to deal (particularly important for listed companies disseminating relevant information), might find themselves being accused of market abuse.

¹³⁴ See, A. Alcock, supra, n 65, at 142.
The F.S.M.A. 2000 gives the F.S.A. the power to take action not only against a market abuser, but also against a person who has required or encouraged another to deal, as in the offence of insider dealing. However, the F.S.M.A. 2000 might give room for the F.S.A. to pursue, for example, the act of disclosing relevant information which is not generally available to a third party i.e., treating the act of inappropriate disclosure itself as a breach the financial promotion regime.\textsuperscript{135} Requiring or encouraging another person; by acting or not acting; in a way to engage in a behaviour that would be considered as market abuse if done directly, is also deemed by the F.S.M.A. 2000 as market abuse.\textsuperscript{136}

6.5.2.2.1. Types of Market Abuse

The behaviour in question must additionally fulfil one of the following three core tests: (a) misuse of information: the behaviour must be based on information which is not generally available to those using the market, which would likely to be regarded by a regular market user as relevant when deciding the terms upon which transactions in investments of the kind in question should be effected; or (b) false or misleading impressions: the behaviour must be likely to give a regular user of the market a false or misleading impression as to the supply of, or demand for, or as to the price or value of, investments of the kind in question; or (c) market distortion: which a regular user of the market would, or would be likely to, regard the behaviour as behaviour which would, or would be likely to, distort the market in investments of the kind in question. In spite of the fact that there are three different classifications of market abuse, they are all a similar underlining crime, i.e. the misuse of information. Thus, the misuse of information is the most important element in the offence of market abuse.

It is also evident from the above definition that unlike Part V of the C.J.A. 1993, the F.S.M.A. 2000 is flexible in a number of ways, particularly in its usage of broad and flexible phrases to define the market abuse offence, such as ‘regular user’, ‘generally

\textsuperscript{135} See the discussion below.

\textsuperscript{136} F.S.M.A., ss. 118(9) and 123(1)(b)
However, the legislature was aware that for a legislation to be too flexible, it would not be credible. Credibility requires that the legislation is not arbitrary (i.e., market users would have a clear view on what market abuse is and what is permissible). In balancing flexibility and credibility, s. 119 of the F.S.M.A. 2000 requires the F.S.A. to produce a code to supply definitions of those flexible phrases, as well as offering guidance to what falls into the category of market abuse. Providing those definitions in a code, rather than within the Act,

137 See, L. Linklater, supra, n 80, 463.

138 The legislator wanted to give the Act flexibility in order for it to be able to adapt the law to quickly meet new situations.

It is worth mentioning here that the Joint Committee of the HoL and HoC on Financial Services and Markets, acknowledged in their second report which was published on the 27th of May 1999, that there was a dilemma on deciding whether the government should take a rigid or flexible approach. The government was aware of the fact that neither too flexible nor too rigid an approach would be effective in securing convictions or liability to wrongdoers. Hence, the government chose to take a flexible approach.

139 Section 119 of the F.S.M.A.2000. Section 119, entitled ‘The Code’ states:

(1) The Authority must prepare and issue a code containing such provisions as the Authority considers will give appropriate guidance to those determining whether or not behaviour amounts to market abuse.

(2) The code may among other things specify-

(a) descriptions of behaviour that, in the opinion of the Authority, amount to market abuse;

(b) descriptions of behaviour that, in the opinion of the Authority, do not amount to market abuse;

(c) factors that, in the opinion of the Authority, are to be taken into account in determining whether or not behaviour amounts to market abuse.

(3) The code may make different provision in relation to persons, cases or circumstances of different descriptions.

(4) The Authority may at any time alter or replace the code.

(5) If the code is altered or replaced, the altered or replacement code must be issued by the Authority.

(6) A code issued under this section must be published by the Authority in the way appearing to the Authority to be best calculated to bring it to the attention of the public.

(7) The Authority must, without delay, give the Treasury a copy of any code published under this section.

(8) The Authority may charge a reasonable fee for providing a person with a copy of the code.
makes room for amendments without referring to Parliament every time.\textsuperscript{140} This fits perfectly with a fast moving and modern market. The Code provided by the F.S.A. is called the Code of Market Conduct (M.A.R. or the Code, hereafter). In May 2001, the F.S.A. published the final version of the Code, which clarifies the kind of behaviour such as insider dealing, market distortion, etc. which is classified as the offence of market abuse. The main aim of the Code is to clarify and illustrate the types of behaviour considered to be market abuse and steps that companies might need to take, as well as issues to be aware of in avoiding committing market abuse. The Code truly gives high-level guidance to market participants as to the behaviour that constitutes market abuse.\textsuperscript{141}

Explaining the meaning of the phrases ‘regular user’, ‘generally available’ and ‘relevant’ is essential to understand the offence of ‘misuse of information’. The only guidance in the F.S.M.A. 2000 on the meaning of the phrase ‘regular user’ is that in relation to a particular market, a regular user is considered as ‘a reasonable person who regularly deals on that market in investments of the kind in question.’\textsuperscript{142} On the basis of reading the F.S.M.A. 2000, one might expect the ‘regular user’ to be an actual market user. However, the Code makes it clear that a ‘regular user’ is in fact a hypothetical user of the market.\textsuperscript{143} The significance of applying a hypothetical

\begin{itemize}
\item \textsuperscript{140} The paragraphs of the Conduct are referred to as MAR.
\item The Code of Market Conduct is now part of the F.S.A.’s Business Standard in the F.S.A.’s handbook.
\item The F.S.A. published a code to supplement the statutory provisions that deal with market abuse and to provide guidance as to whether or not behaviour is abusive. The first draft of this code was published in June 1998 and on 25 July 2000. The F.S.A. then published a revised version of the code in consultation paper number 59 (CP59). However, in CP59 the F.S.A. indicated that it would be issuing a supplementary paper on the interaction between the City Code on Takeovers and Mergers and the Code, the inclusion of safe harbours for certain of the F.S.A.’s L.R. and the position of intermediaries who execute transactions on behalf of customers on prescribed markets. This supplementary paper (CP76) was published in December 2000.
\item \textsuperscript{141} See, Market Code, para. 1.3.
\item \textsuperscript{142} See, s. 118(10) of the F.S.M.A. 2000.
\item \textsuperscript{143} Para 1.2.2 of the Code of Market Conduct (MAR) states:
\begin{quote}
‘In determining whether behaviour amounts to market abuse, it is necessary to consider objectively whether a hypothetical reasonable person, familiar with the market in question, would regard the behaviour as acceptable in the light of all the relevant circumstances.’
\end{quote}
\end{itemize}
person, rather than an actual user, is to deal with occasions on which the standards that are in fact accepted by actual users may not be deemed to be objectively acceptable to the hypothetical 'regular user' and visa versa. Hence, behaviour may fall below the standard of the hypothetical 'regular user' when it is knowingly tolerated on a regular basis by the actual user.

The phrase 'regular user' establishes two standards in the context of the offence of misuse of information. The first standard is related to the offence generally. The test is whether the 'regular user' would be likely to consider the behaviour of the alleged offender as a failure to observe the expected standard of behaviour. The second is related to whether the information is relevant or not. The test applied is whether a 'regular user' would be 'likely to' consider the information as 'relevant' when deciding upon the terms on which transactions in investments of the kind in question should be affected. In order for it to amount to market abuse, the behaviour in question must, in each case, meet the 'regular user' test. Hence, it is worth noting that unlike the offence of insider dealing (under the C.J.A. 1993), there is no requirement for the information to be 'specific' or 'precise'.

The Code also recognises that the standard of expectation of a 'regular user' differs according to the experience, level of skill and standard knowledge of the person in question. The approach here seems different to the approach applied by the 1993 C.J.A. In fact, such an approach is similar to the American approach. In the U.S.,

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144 MAR 1.2.4 states:
‘The regular user is likely to consider it relevant, although not determinative, that the behaviour conforms with standards that are generally accepted by users of the market.’

145 The F.S.A. describes the test as premised upon the notion of a 'hypothetical, reasonable person', who is familiar with the markets and 'whose judgement of behaviour is impartial and objective' and who understands that standards between different markets may vary. The F.S.A. has said that although the hypothetical user is not the regular user, in many instances, may share his or her views.


147 See, s. 118(2)(a) of the F.S.M.A. 2000.

148 MAR 1.2.3. The Financial Services and Market Tribunal (F.S.M.T.) sets the 'regular user' standard.
courts seem to apply a dual test which is both subjective and objective, in deciding whether the information has affected the securities price or not. As mentioned earlier, The American Second Circuit in *Elkind v Liggett & Myers, Inc*\(^{149}\) held:

[a] skilled analyst with knowledge of the company and industry may piece seemingly inconsequential [non-public] data together with public information into a mosaic which [viewed as a whole] reveals material non-public information.

The recognition of the level of skill, standard knowledge and experience of the person in question is of particular importance to institutional investors, investment managers and financial analysts. This is because of their ability to mix published information with information that is acquired from corporate management (which is not price sensitive), to make a judgment on how the company is performing and then deal with securities accordingly. There is no case law yet to support or refute this in the U.K. If the U.K. courts are to take such a position, this might well be a major blow to the dialogue between investors and corporate managers. There are however, signs to suggest that the U.K. market may be heading in this direction. Mr. Davies (the former Chairman of the F.S.A.) recently stated\(^{150}\) that private briefing is damaging for the market's integrity.\(^{151}\) This affirms the F.S.A.'s commitment to prevent selective briefing or the leaking of price sensitive information, which could significantly affect the share price of listed companies.\(^{152}\) Mr. Davies' speech represents a tough stance against selective briefing.\(^{153}\)

\(^{149}\) 35 F.2d 156 (2d Cir. 1980)

\(^{150}\) Howard Davies was addressing a Bloomberg lunch in London on the 25 of October, 2000. The full text of his remarks and the F.S.A.'s 'Guidance on the Dissemination of Price Sensitive Information', are available on the F.S.A.'s website at:

<http://www.fsa.gov.uk/pubs/speeches/sp61.html>, and:


\(^{151}\) In the U.S., the Securities Exchange Commission has recently introduced new regulations that came into application before Mr. Davies' speech, ensuring that individual investors receive the same information as institutional investors and market analysts, (see for example, L. Kellaway, n 128).

\(^{152}\) For example, Mr Davies said: 'In fast moving equity markets the timely flow of accurate information to investors is crucial. It is especially important in present circumstances given the large number of new small investors who have been attracted into equity markets in the last couple of years. This is a very welcome trend. But it could be set back if small investors believe that they are not allowed access to information on a similar basis to large institutions.
Another point of disagreement between the new market abuse offence and inside dealing under the C.J.A. 1993, which is related to the phrase 'regular user', is the source of information. Unlike the C.J.A 1993, the F.S.M.A. 2000 does not require proving that the offender had knowledge that the information was inside information and that it was obtained from an inside source.\textsuperscript{154} Thus, under the F.S.M.A. 2000, insiders are no longer limited to directors, employees, shareholders, and anyone who holds inside information by virtue of her/his position in the company. In fact, under the F.S.M.A. 2000, a person who acquired privileged information from the rubbish bin outside the company building and dealt upon it, might be covered by the market abuse offence.\textsuperscript{155}

The phrase 'generally available' is another example of the flexibility of the language used in the F.S.M.A. 2000. The F.S.M.A. 2000 deems information that can be obtained by research or analysis, by or on behalf of market users, to be 'generally available'. Section 118(7) of the F.S.M.A. 2000 states:

\begin{quote}
[i]nformation which can be obtained by research or analysis conducted by, or on behalf of, users of a market is to be regarded for the purposes of this section as being generally available to them.
\end{quote}

Such an approach provides protection for market analysts, institutional investors and investment managers. Also, and unlike s. 57 of the C.J.A. 1993, the F.S.M.A. 2000 does not require that the information is obtained from an inside source or that it must be 'known' to be non-public.\textsuperscript{156} Here, the F.S.M.A. 2000, links the term 'generally available' to the term 'regular user', requiring that information would amount to an advantage that a 'regular user' of the market might judge as relevant, and that the 'regular user' would expect a reasonable person not to use in dealing with the

\begin{quote}
There is nothing more corrosive of market confidence than the feeling that some investors are deliberately excluded from an inner circle of privileged counter parties. And in addition to the positive benefits of a well-informed market, a rule of this kind helps reduce the scope for insider dealing, by getting price sensitive information quickly into the public domain.\textsuperscript{7}
\end{quote}

\textsuperscript{153} The implications of Mr. Davies speech are discussed in greater detail in the section below.

\textsuperscript{154} See, ss. 52(1) & 57(1) C.J.A. 1993.

\textsuperscript{155} See, L. Linklater, supra, n 80, at 467.

\textsuperscript{156} See discussion below in this chapter.
company's securities. The prerequisites required here are different in the U.S. from that in the E.C. In the U.S. the Supreme Court held that, in interpreting section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 in the case of United States v O'Hagan, market abuse must involve some exploitation of a breach of confidence.

Thus, the U.S. courts continue to apply the 'traditional' or 'classical theory' in linking market abuse to a breach of confidence of the source of information. A violation of s. 10(b) and Rule 10b-5 (insider trading liability), only occurs when a corporate insider trades in his corporation's securities on the basis of material, confidential information he has obtained by reason of his position. Such trading meets the criteria of a 'deceptive device'. This was the U.S. Government's position in the above mentioned case of United States v O'Hagan, known as the complementary 'misappropriation theory'. This is because there is a relationship of trust and confidence between the corporation's shareholders and the insider that gives rise to a duty to disclose or abstain from trading. On the other hand, the European Commission's more liberal view asserts that any exploitation of an information advantage would amount to market abuse.

6.5.2.2.2 Some of the Main Points in the Code of Market Conduct (MAR)

One of the main points that the Code stressed is that, companies should consider making their policies regarding manners of communication with shareholders and analysts, known publicly. This would help companies to refer to those polices in response to pressure placed upon them by some financial analysts, media analysts or any other market participants that require, for example, clarification of an

157 See A. Alcock, supra, n 65, at 143.
158 521 US 642 (1997). The U.S. Security Exchange Commission challenged the judgement unsuccessfully in these cases for example:

159 Chiarella v United States, 445 U.S. 222, 228-229, 100 S.Ct. 1108, 1114-1115, 63 L.Ed.2d 348.
announcements. Hence, companies are urged to have a structured communications plan with regular updates on their trading position and immediate prospects. The Code also encourages companies, when issuing a lengthy release to the market, which includes comments or future trading prospects, to give those details the due prominence. This would help market participants' speculation and hence, reduce the volatility of share price. Furthermore, announcements should be used where a company and its advisers believe that there is a danger that information about an unexpected or significant event might leak, where the facts cannot be confirmed. If price sensitive information is inadvertently released, a company should take immediate steps to ensure that the whole market has access to the same information, the main reason being to prevent insider dealing.

The Code also drew listed companies' attention to how to approach correcting public forecast as soon as possible, if the outcome is significantly different. Yet, the Code suggested that companies should not be drawn into rectifying any incorrect price sensitive information or assumptions. Such a rule might have been designed to overcome the problem which companies may encounter when a group of market participants, particularly media analysts, agree between themselves to ask a set of different questions, in which the answer of each question in itself does not carry significant price sensitive information, although collectively, the answers would hold significant material information. The other potential problem that such a rule may overcome is similar to the so-called 'devil's advocate' technique. In this alleged practice, a market participant would make a comment about corporate performance, expecting the manager to agree or disagree about the comment, revealing material price sensitive information in the process. The Code conveys that companies should be prepared to give a 'no comment' answer where journalists, analysts or shareholders are pressing for price sensitive information. Having said that, the Code recommends that where there is a risk that sufficient price sensitive information has been collected for a story is broadly accurate, a company should ensure the proper information is widely available.

The Code also provides 'safe harbours' from being charged of market abuse. Although the safe harbours provided by the F.S.M.A. 2000 and the Code definitely
do not amount to market abuse, they are meant to be indicative rather than conclusive indicators. Otherwise, the 'regular user' would be applied. The F.S.M.A. provides the F.S.A. with various powers to create a series of limited 'safe harbours' from a charge that a market participant has engaged in market abuse. These series include, for example: (a) certain aspects of the City Code on Takeovers and Mergers, and the Rules Governing the Substantial Acquisitions of Shares; (b) 'Chinese Wall' provisions. The Code also listed 9 specific safe harbours.

Under the F.S.M.A. 2000, the old concepts of 'investment advertisement' and 'unsolicited call' are replaced with the single concept of 'financial promotion'. Within the financial promotion regime, 'unsolicited real time communications' (which includes telephone calls but not emails) are more tightly regulated than 'non-real time communications'. The F.S.M.A. 2000 intentionally defines 'financial promotion' broadly and encompasses any invitation or inducement to engage in investment activity communicated in the course of business. The term 'investment activity' may include entering or intending to enter into an agreement to sell or purchase shares or other securities. Other than in a case where exemptions apply, such a communication ought to be made either by an authorised person, or an authorised person must approve the contents of the communication.

Currently, companies need to take great care in disseminating information. Failing to take into account the financial promotion regime (even if it inadvertent), is a criminal offence. This may result in agreements being rendered voidable. Of course, not all communications by a company will constitute a financial promotion. There are significant exemptions that have provided for a wide variety of communication techniques. This includes: certain communication with a company's shareholders; certain communication that consists of, or are accompanied by the annual accounts of the company or a report prepared and approved by the company's directors under the C.A. 1985, subject to certain content and form restrictions; and, certain communication that is required or permitted to be communicated by the L.R., including half-yearly reports, preliminary and interim announcements, and the

161 The F.S.M.A. 2000, ss. 118(8), 119(1), 120 and 122(1).
162 Paragraphs, 1.1.10 and 1.7.
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annual report and accounts. After elaborating on market abuse offences, the next title examines the case of shadow directors, as a restrain on dialogue between market participants and corporations managers.

6.5.3. Shadow Directors as a Restraint on Dialogue

For a significant shareholder, liability for directors' actions could be a reason for abandoning the role of monitoring corporate management. Such a close relationship between a shareholder and management could lead to the significant shareholder being perceived as a shadow director. The unattractiveness of being considered as a shadow director is being held responsible for directors' actions. For example, according to s. 214 of the I.A. '1986, a shadow director's liability can occur in the context of wrongful trading. However, the question is, how viable is it for a controlling shareholder to be potentially at risk of being classified as a shadow director?

In answering the above question one needs to define what a shadow director actually is. According to s. 741(2) C.A. '1985, a shadow director:

[...]

Thus, establishing whether or not a person is a shadow director is a question of facts. The question that needs to be asked here is: whether a person has exercised real influence in the conduct of a company's affairs, for the court to consider them as a shadow director.

The court of appeal elaborated on the meaning of the statutory definition of shadow directors in Secretary of State for Trade and Industry v Deverell. LJ Morritt,

164 For example, in this case Re PFTZM Ltd, Jourdain v Paul [1995] 2 BCLC 354, the court observed that the alleged shadow directors were rightly trying to rescue what they could from the company, rather than being accustomed to giving directions.
165 [2000] 2 BCLC 133 at 144-145

235
inter se, listed the following proposition:

Whether any particular communication from the alleged shadow director, whether by words or conduct, is to be classified as a direction or instruction must be objectively ascertained by the court in the light of all evidence. In that connection I do not accept that it is necessary to prove the understanding or expectation of either giver or receiver. In many, if not most, cases it will suffice to prove the communication and its consequence. .... Certainly the label attached by either or both parties then or thereafter cannot be more than a factor in considering whether the communication came within the statutory description of direction or instruction.

Accordingly, there is no doubt that controlling shareholders (in the factual sense, rather than legal) are most at risk of being classified as shadow directors. However, should that prevent significant shareholders from having dialogue with corporate managers? The answer is no. This is due to the fact that to establish that a significant shareholder is a shadow director, it is necessary to prove, as Millett J sated in Re Hydrodam (Corby) Ltd,166 the following:

(i) who are the directors of the company, whether de facto or de jure;
(ii) that the [significant shareholder] directed those directors how to act in relation to the company or that he was one of the persons who did so;
(iii) that those directors acted in accordance with such directions;
(iv) that they were accustomed to act.

What is needed is, first, a board of directors claiming and purporting to act as such; and, secondly, a pattern of behaviour in which the board did not exercise any discretion or judgment of its own but acted in accordance with the directions of others.167

Conducting dialogue with corporate managers, voicing concern, expressing one's views to change certain policies, or even directing the board to act in a certain manner (but nor as a regular practice), does not meet with the above set criteria.168 It rather must be established that the directors of a company had to act on the directions or instructions of a shadow director, as a matter of regular practice over a period of time as a regular course of conduct.

Having looked at some of the legal constraints on dialogue among shareholders and management, it is now appropriate to examine the constraints on dialogue among

168 See Re Unisoft Group Ltd (No 3) [1994] 1 BCLC 609 at 620; see also, Secretary of State for Trade and Industry v Becker [2003] 1 BCLC 555.
shareholders *inter se* and what happens in practice. In support of the discussion, empirical evidence from the responses of institutional investors and investment managers who participated in the questionnaires of this study will be presented. One recognises that institutional investors and investment managers' ability to monitor corporations and their managers is (as well as the above mentioned factors), also based on collective action. Collective action is indeed needed to secure a majority when, for example, voting against certain corporate management proposals. However the rules of disclosure and the concept of the 'concert party'\textsuperscript{169} are thought to reasons why shareholders abandon dialogue *inter se*. Examining the reasons that affect collective action and coalition building is the subject for discussion under the next section.

### 6.6. Investors' Collective Action against Corporate Management

A shareholder might sometimes be successful in convincing corporate managers to respond to his/her concerns when they voice apprehension about matters related to the way the corporation is managed.\textsuperscript{170} Nonetheless, if corporate managers are not responding, or even listening, and the shareholder still feels that action must be taken to make corporate managers comply, he or she might resort to 'collective action' with other shareholders. Collective action needs 'coalition building' and coalition building needs dialogue among investors *inter se*. For example, shareholders when feeling that there is a need to stand up to a management proposal or defeat a management resolution, could use coalition building to hold corporate managers to account. However, successful coalition building might not be as easy as it sounds.

\textsuperscript{169} The term 'concert party' is used by the C.A. '1985 and the Takeover Code referring to a set of rules that consider a group of shareholders as one unit when they work in concert. The issue of 'concert party' and its negative impact on coalition building is subject to further elaboration and discussion in section 6.6.1. of this chapter.

\textsuperscript{170} A distinction between individual and collective acts as a means of holding management to account was drawn upon in chapter one. This section is primarily concerned with the latter i.e., collective action. Hence the term 'single shareholder' refers to the act performed by one single shareholder, without the help of other shareholders.
In fact, historically; from just before the great market crash in 1931 in America and similarly in the 1950s utile the 1980s in the U.K.; coalition building was thought to be impossible in big corporations since shareholding was too widely dispersed. However, the sharp increase in institutional shareholding in the late 1980s up until the mid 1990s caused legal scholars to believe that coalition building was in fact, a realistic possibility. This section aims to test whether or not coalition building is an easy process in the U.K. as far as corporate governance is concerned. In achieving its aim, this section seeks to gain an insight to the frequency of dialogue in the U.K. stock market and legal or other reasons that might affect coalition building in the U.K.

This section has two objectives. The first objective is to explore the frequency of dialogue between investors *inter se*, particularly, institutional shareholders and investment managers. This includes: dialogue among institutional shareholders; dialogue among investment managers; and, dialogue between investment managers and institutional investors. The second objective is to examine the possibility of a conflict of interests between institutional investors and investment managers on one hand, and private investors on the other hand. This is particularly important in looking at the eligibility of institutional investors and investment managers to take a leading role in corporate governance as corporate owners. This section presents findings based on the responses of institutional investors and investment managers to the questionnaires executed for this study, on dialogue and communications between investors and management, as well as setting out the legal and financial reasons which might prevent shareholders’ coalition building to oppose corporate management decisions, etc.

The section is organised into four subsections. The second subsection examines the relationship between individual shareholders or individual external equity managers, and corporate management. The third subsection considers the relationship between shareholders as a collective body and investment managers on one hand, and companies’ management on the other. Before the research findings on dialogue are discussed, it is also essential to examine the legal limitations attached to dialogue.
6.6.1. The Relationship among Shareholders as a Collective Body, Shareholding Thresholds and Concert Party

The European Council Directive 88/627/EEC\textsuperscript{171}, on the information to be published when a major holding in a listed company is acquired or disposed of, must be implemented by all member states. Under the Directive, persons (natural or otherwise) who acquire, hold (directly or through intermediaries) or dispose of holdings, in an officially listed company on a stock exchange in a member state which reach, exceed or fall below 10\%, 20\%, 1/3, 50\% or 2/3\textsuperscript{172}, must inform the company and the competent authority, of the proportion of the voting right that they have reached. The public should be able to access such declarations within nine calendar days after the receipt by the company.\textsuperscript{173} The thresholds of 20\% and 30\% do not need to be applied if the Member State has chosen a single threshold of 25\%.

The European Council Directive 88/627/EEC had little impact in the U.K., however. This is because the principle of disclosure is longstanding and established upon the recommendations of the 1945 Cohen Committee.\textsuperscript{174} In fact, the U.K.'s obligations for disclosure are more demanding that the Directive. For example, in the U.K., the starting threshold for disclosure is less than the current 10\% threshold set by the European Council Directive. Specifically, the threshold for disclosure starts at 3\% in the U.K. Moreover, the U.K rules for disclosure are generally speedier than the European Council Directive.

The underlying rationale of these rules of disclosure according to Davies, is in part, to deter insider dealing.\textsuperscript{175} However, the main rationale as outlined by the Department of Trade is as follows:

A company, its members and the public at large should be entitled to be informed promptly of the acquisition of a significant holding in its voting shares ... in order that existing members and those dealing with the company may protect their interests and those dealing with the company is not

\begin{itemize}
\item [172] See, Articles 1, 4, 5 and 6 of the Directive.
\item [173] Article 10 of the Directive
\item [175] ibid. at 485.
\end{itemize}
prejudiced by uncertainty over those who may be in position to influence or control the company.\(^{176}\)

The above statement reveals that the rationale behind these rules is largely to protect corporate management and to some extent corporate members, by making them aware of an investor who is building a stake in the company. Hence, the disclosure rules here, work as an early warning device about a possible takeover bid facing a particular company.\(^{177}\) Yet, the problem with such rules is that it might restrict institutional investors and investment managers’ ability and willingness to building stakes within a company. Similarly these rules may negatively affect coalition building, because if institutional investors and investment managers fall under the rules of concert party, they would collectively be subjected to the disclosure rules when they, collectively, reach a certain threshold. For example, in *Philip Morris Products Inc v Rothmans International Enterprises Ltd (No.2)*\(^ {178}\) it was held that ‘control’ of a target company within the meaning of the Takeover Code\(^ {179}\) could be acquired by a shareholder(s) that held less than 30% in aggregation of their shareholdings. Such disclosure rules could indeed put institutional investors off constant dialogue, unless they wanted to commit themselves to a takeover offer.

Recently however, there has been some speculation about the existence of dialogue between shareholders behind the scenes in the U.K. to discuss corporate performance.\(^ {180}\) Legal scholars such as Stapledon have also speculated that in British listed companies, a group of institutional shareholders who own between 20 to 30% of shares; numbering at no more that three or four institutional shareholders, can control a company.\(^ {181}\) According to Stapledon, this is due to the practical difficulties

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176 The quote is taken from P. Davies, supra, n 174, at 484-485.
177 P. Davies, supra, n 174, at 485.
178 Times, August 10, 2000 (Ch D).
179 Takeover Panel’s Rule 9.1 [6].
181 Stapledon argues: ‘Interviews of UK fund managers by the present author found that the attempted replacement of an under-performing or otherwise unacceptable management team normally requires for its success a group of institutions (a) controlling (between them) 20-30 per cent of the equity, and (b) numbering no more than three or four (due to the practical difficulties with co-ordinating a larger group)’.
with co-coordinating a larger group, and hence, the number should not exceed three to four institutions. Yet, forming such a coalition firstly requires dialogue and as a result, the research conducted for this study sought to examine dialogue among institutional shareholders *inter se*, dialogue between institutional shareholders and their external equity managers, and dialogue among investment managers *inter se*.

In examining dialogue amongst institutional shareholders *inter se*, the question posed was, how often an institution discusses corporate performance with other shareholder(s) in the companies in which they both held shares. Table 6.6 (see Appendix I) illustrates that less than 8% of institutional investors discussed corporate performance with other shareholder(s) in the same company on a systematic three to twelve monthly basis, while only 14.7% of institutional investors held dialogue about corporate performance on an *ad hoc* basis, such as when a problem appeared. A majority of over 73.5% of institutional shareholders never had dialogue with other shareholders. This might be due to the fact that they expect investment managers to conduct dialogue for them.

Institutional investors who did have dialogue with other investors were asked to give details of the type of shareholders with whom they discussed corporate performance. In Applying Stapledon's argument that for institutional investors to succeed in controlling an under performing company, three to four institutional investors

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Stapledon then provides results of his 1993 U.K. study of 695 companies (G. Stapledon, ‘The Structure of Share Ownership and Control: The Potential for Institutional Investor Activism', (1995) 18 (2), *The University of New South Wales Law Journal*, 250, at 264) showing 'that, even if the top three or four institutions are assumed to compose the institutional coalition, as at 1993, it was only in small and (to a lesser extent) medium-sized UK companies that an ideal coalition could have been formed. This may partly explain why, out of a couple of dozen institutional interventions which were reported in the financial press during 1990-1993, only one involved a Top 100 company.'

182 Institutional investors' questionnaire, control number 3.

183 Two institutional investors made comments explaining why they never hold discussions with other shareholders about corporate performance. Institutional investors' questionnaire, control number 278 claimed: 'Leave to external managers'. Institutional investors' questionnaire, control number 652 stated: 'Left to investment manager.'
should hold 20 to 30% of the shares between them, this necessarily means that each institutional shareholder should hold the average of 5 to 10% of the company's shares. The sample of institutional investors that participated in this study did not show evidence of holding such a percentage and it is definitely unusual to have shareholding at that level in F.T.S.E. 100, for example. Furthermore, and although it is limited to the sample of this study's questionnaires, Table 6.7 (see Appendix I) does not particularly demonstrate institutional investors' consideration of have discourse with institutional shareholders who hold between 5 to 10%. Only 17.3% of institutional investors had dialogue with other institutions that hold 3% or more and similar figures of 13%, hold dialogue with institutional investors that hold less than 3%.

It appears that for the majority of the respondents of this study's questionnaires, the size of an institution does not matter a great deal when institutions consider holding discussions with their institutional counterparts. In fact, and as Table 6.7 (Appendix I) shows, institutions tend rather to engage in dialogue with individual shareholders. Three quarters of the institutional investor respondents preferred to have dialogue with individual shareholders. This is a very interesting finding; however, one should be cautious before further research is conducted on this issue. Unlike the position of institutional investors on holding discussions with institutions, it seems that the size of an individual shareholder's investment does in fact make a big difference when institutions consider having discussions with them.

Table 6.7 (Appendix I) suggests that the proportion of institutional shareholders who hold discussions with individual shareholders falls from 65% when individual shareholders hold 3% or more of the shares, to only 5% when individual shareholders hold less than 3% of the shares. However, it should be noted that one could not rely on the figures in Table 6.7 (Appendix I), since the number of responses is rather small. It is surprising that the number of institutional investors who discuss corporate performance with institutional shareholders holding 3% or more is just 17.3%, while the amount of institutional shareholders that conduct discussions regarding corporate performance with individual shareholders who hold 3% or more, goes up to 65.2%.
The questionnaire then focused on the regularity with which institutional investors hold discussions about corporate performance with their investment managers. Unlike the dialogue amongst institutional investors, dialogue between institutional investors and their external equity managers is rather solid. Table 6.8 (Appendix I) shows that 70.5% of institutional investors have dialogue with their external equity managers on a systematic basis of one to twelve months. 52.4% of institutional investors have regular dialogue between one to three months. These results are not surprising, considering the fact that such dialogue seems to be the only means by which shareholders can monitor the progress of the investment performance of their external managers.

The same question was asked to investment managers. The results here, showed a lower tendency to conduct dialogue. Table 6.9 (Appendix I) illustrates that 64.2% of investment managers believed that dialogue took place on a systematic basis between shareholders and investment managers, on a one to twelve months basis. The difference in results between the two questionnaires might be attributed to the fact that investment managers may manage the investment of shareholders other than institutional shareholders, such as individual shareholders. However, the fact that 28.6% of investment managers thought that dialogue never took place with shareholders is striking and requires further investigation, since one would be inclined to believe that dialogue ought to be established between investment managers and their clients in some form or another.

In realizing the potential importance of the role that investment managers can play in organizing collective action to control corporate governance, one needed to examine which group(s) of shareholders investment managers discuss corporate performance with. Table 6.10 (Appendix I) shows that 60% of investment managers have discussions about corporate performance with institutional investors, regardless to the percentage that they hold. Only 10% of the investment manager respondents have dialogue with individual investors, again with no difference to the amount of shares that they hold. In fact, investment manager respondents have dialogue with individual investors who hold less than 3%. It appears that when it comes to
dialogue, (at least among the sample who participated in the questionnaires of this study), size does not matter. This is of course, somewhat differs from Stapleton’s model of corporate control, based on the notion that three to four shareholders need 20 to 30% of the shares in a company in order to control corporate governance.

6.6.2. The Relationship between Investment Managers Inter Se

In examining the level of dialogue between investment managers *inter se*, the questionnaire asked investment managers about the frequency of their discussions on the performance of a company, with other investment manager(s) who held shares in the same company. Despite the fact that investment managers are business rivals, one would expect to find good communications between them for the simple reason of benefit for all. However, Table 6.11 (Appendix I) shows that 50% of investment managers never have dialogue with other investment managers. It is also manifest that only one (7.1%) of the investment manager respondents has dialogue on a systematic basis (specifically quarterly), 35.7% investment managers have dialogue only on an ad hoc basis. It appears that those investment managers that conduct dialogue, do so mainly when a company is performing badly and a change of management is required.184 As one investment manager put it: ‘very rare (NB: rules on ‘concert parties’).’ This is a very useful observation, which means that if investment managers talk often to other investors, they may be in danger of being regarded as a ‘concert party’. The level of dialogue between investment managers casts some doubt on whether they can play the ‘leading role’ expected of them to play, in bringing management to account. The next title examines the various conflicts of interest which arise between both institutional investors and investment managers, as well as between both shareholders and investment managers, and corporate management, and the effects this has on the effective monitoring of corporate management.

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184 Investment managers’ questionnaire, control number 222.
6.6.3. Conflict of Interests

Dialogue between shareholders and their external investment managers can be important in ensuring that investment managers carry out the will of investors, including responsible investment policy and accountability for their role in corporate governance. It is also the case that investment managers should be monitored by their shareholders' clients because of the potential conflict of interests between investors and investment managers, on issues such as the length of the investment and socially responsible investment. Institutional investors were asked whether they believe that the interests of shareholders differ from the interests of investment managers. Table 6.12 (Appendix I) shows that 57.8% of institutional investors believed that the interests of shareholders are different from those of investment managers, while 40.2% believed that the interests of shareholders are not different from those of investment managers. The same question was asked of investment managers. Table 6.13 (Appendix I) shows that the majority of over 71.4% of investment managers thought that the interests of shareholders do not differ from the interests of investment managers, and only around 28.6% believed that shareholders' interests differ slightly.

Both institutional investor and investment manager respondents provided various examples of the potential issues related to a conflict of interests. The areas in which institutional investors' interests might be different from the interests of investment managers can be divided into five areas, which are: time scale; socially responsible investment; senior corporate managers' remuneration; duty to trustees vs. duty to owners; and investment managers duty to different groups of investors when their interests differ.

First, time scale, where both groups of respondents seemed to agree that the length of time for which an investment is held is an issue where a conflict of interests arises. 25% of institutional investors provided 'time scale' as an issue of a conflict of interests with investment managers. However, institutional investors disagreed on
whether investment managers had longer or shorter-term investment aims than themselves. Nevertheless, the vast majority of those institutional investors (92%) who provided time scale as an area where interests are different between institutional investors and investment managers, considered themselves to be longer-term investors. It is probably not surprising that 96% of the institutional investors who thought the issue of time scale may cause a conflict of interests between shareholders and investment managers were pension funds. One pension fund stated: 'A pension plan looks over a longer term than perhaps external investment managers do.' Institutional investors might feel that investment managers have a short-term perspective and therefore are prepared to take quick gains through, for example, takeovers.

Institutional investors might also perceive themselves as being more loyal to the company than investment managers are. One institutional investor even accused investment managers of having a lack of compassion to change the wrong in companies, stating that:

[M]anagers are seeking the best returns for their clients and will switch to achieve that. Shareholders are investing in a company which they hope will produce returns and may work to change a company rather than abandon it.

Investment managers agreed that time scale could be an issue of a conflict of interests between themselves and shareholders. One investment manager stated

186 Institutional investors' questionnaire, control number 724.
187 Institutional investors' questionnaire, control number 3.
188 Institutional investors' questionnaire, control number 733 stated: 'Shareholders may have loyalty to company, managers have to reach target returns'.
189 Institutional investors' questionnaire, control number 38.
190 Institutional investors' questionnaire, control number 437: '[D]ue to views on risk – shareholders may not want to strive for maximum return.'

Institutional investors' questionnaire control number 440: '[R]isk, stability, protection, efficiency.'

Institutional investors' questionnaire, control number 586: '[T]hey are taking a longer-term view of investments. Will use influence if they feel need for changes at company.'

Institutional investors' questionnaire, control number 728: '[C]riteria of 'return' may differ.'

Institutional investors' questionnaire, control number 738: '[N]eed to buy / sell.'
that: 'Investment managers are required to outperform the index and their competitors on a relative basis over, usually, a 3 years period. Individual shareholders can take a longer term view.'

Second, is the issue of socially responsible investment. Institutional shareholders indicated that socially responsible investment could be an issue where their interests might be dissimilar to the interests of investment managers. The meaning of the term 'socially responsible investment' might be rather baffling to many people. As a term, socially responsible investment is neither the same as the term 'ethical investment', nor is it the equivalent to 'putting principles before returns investment'. Socially responsible investment could rather mean to some investors that it is a form of investor engagement in corporate governance.

Socially responsible investors would normally identify a good corporation with the aim of improving its potential. In the process, socially responsible investors, unlike ethical investors, would use their weight individually and collectively with other investors of the same viewpoint, to negotiate with the corporation how to improve their practices on a social level. Organisations that apply the method of coalition building in order to follow the best practice in social responsibility in the U.K. are: Hermes, Ivory & Sime and Co-operative Insurance. Socially responsible investment is concerned with a range of issues from those related to managing the business such as management structure (e.g. the role of chairman/chief executive), and business behaviour, to social and environmental concerns. Though 'ethical investment' is maybe similar to socially responsible investment on issues of concern, the approach in handling matters differs. Before placing an investment in a corporation, an 'ethical investor' normally looks at whether the company meets its ethical criteria and, if it does not, then no investment is made. Likewise, the investment would be sold if the company the 'ethical investment' was placed in began to behave in a way that did not meet the ethical criteria of the investor.

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191 Investment managers' questionnaire, control number 169.

As mentioned above, socially responsible investment to some is not concerned with putting principles before returns. It is rather concerned with better managed companies. The socially responsible investment approach entails that better run companies would normally make better investments and hence, give better returns, (i.e., the equation does not have to be socially responsible investment versus returns). This is particularly true with the current trend of socially responsible customers. A public opinion survey published by the Co-operative Insurance Society Ltd at the end of the year 2000, showed the great pressure on businesses to be more socially accountable. Over 90% of the public felt that businesses do have a duty towards society.

Hence, the main difference between, ethical investment and putting principles before returns investments, and socially responsible investment, is that socially responsible investment principally works by investors using their weight in holding dialogue with corporate managers to pressurise companies to follow best practice. Ethical investors and those investors who put principles before returns, would not invest or would dispose of their investment if the corporate does not fit their set criteria. A socially responsible investor would also use the available corporate governance machinery in order to make their voice heard. They would attend the company G.M. and vote on its resolutions, regardless of size. Institutional investors see themselves as more socially responsible than investment managers. It is not surprising to find that institutional investors, especially pension funds for local government, are concerned about socially responsible investment issues such as 'green issues', as they may have an institutional view or party policy on such issues.

Third: executive remuneration. Some institutional shareholders thought that, '[c]orporate governance issues are typically of less importance to investment managers than to shareholders'. The reason for this, according to one institutional investor, is that '(e)xternal managers may be less interested in pursuing sensitive issues'.

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194 Institutional investors' questionnaire, control numbers 206 and 652.

195 Institutional investors' questionnaire, control numbers 113 and 652.

196 Institutional investors' questionnaire, control number 210.
governance issues as the company may be a client or potential client." Hence, board compensation and remuneration could be seen as an issue where a conflict of interests between shareholders and investment managers might arise. Without going into detail about the issue of board compensation, the managers of institutional investors and investment managers would in reality, arguably have no incentive to fight against corporate managers' high remuneration packages. This is because, market high remunerations packages would in turn (though indirectly) result in high remunerations packages for themselves. However, it might be true to say that investment managers seem to less interested in board remuneration, claiming that they are more interested in financial performance.

Fourth is that the duty to trustees vs. duty to owners. Some institutional shareholders see investment managers as prioritising the growth of their own business; befitting their own business, over the business of their clients. This might be due to the movement 'towards takeovers within the financial management industry', which has resulted in some investment managers holding their own funds. This brings to light the question of who would then control investment managers. Investment managers might have commercial relationships through parent companies or through their own shareholders with a company, and so form comfortable relations with that company, which might result in less effective monitoring of corporate management.

Fifth is that investment managers' duty to different groups of investors when their interests differ. The fact that investment managers invest for a number of shareholders might mean that they take the majority view in deciding on a matter.

197 Institutional investors' questionnaire, control number 104.
198 Institutional investors' questionnaire, control number 652.
199 Institutional investors' questionnaire, control numbers 4, 7, 107, 122, 133, 198, 212, 314, 343, and 634.
200 Institutional investors' questionnaire, control number 634.
201 Institutional investors' questionnaire, control number 634.
202 Institutional investors' questionnaire, control number 314.
203 Institutional investors' questionnaire, control number 133.
204 Institutional investors' questionnaire, control number 724.
This might entail that investment managers cannot carry out the will of all shareholders. Investment managers’ questionnaire, control number 169, stated that: ‘[I]nvestment managers cannot take individual shareholders’ (or their own) views into account where they may conflict with the majority view.’

A conflict of interests arises because price sensitive information would, unless other measures were arranged, such as applying ‘Chinese Walls’, restrict institutional investors’ and investment managers’ ability to deal with shares. ‘Chinese Walls’ are used to separate departments in those firms and institutions, which need to perform duties that might cause a conflict of interests. Investment managers and institutional investors sometimes use ‘Chinese Walls’ to avoid sharing information between the representatives that are appointed by institutional investors and investment managers in the board of directors as non-executive directors (in the companies that they have or manage investment in), and the employees of the institutions and firms that they represent. The bottom line is to avoid serving two ‘masters’ at the same time. The issue of whether ‘Chinese Walls’ work in reality, is another issue that is definitely beyond the objectives of this study.

‘Chinese Walls’ are even more of a complex issue in such organisations. Investment banks advise buyers of equity (the investors), as well as the issuers of equity (companies), on the same transaction. The conflict of interests is extended further in its complication when investment banks or other firms in the same group act as proprietary traders, which means that not only do banks then act as both buyer and seller, but also compete against both parties. Such illustrations of conflicts of interest that may arise, brings one’s attention to the importance of insider dealing regulations. Of course, insider dealing regulations do give some protection to the conglomerate’s clients in such an integrated model.

Augar (former head of equities at Schroders) identified three accounts where the integrated model failed the transparency tests. First, where it is possible to advise a client to issue equity at a certain price, then to advise another client to buy it at the

205 Lex Column: Fund Management, supra, n 63, at 1 and 20; see also, J. Willson, supra, n 63, at 12.
same price, and for the advice to be 'fair for both parties'. Second, the intermingling of corporate finance when advising the buyers, the issuers, and as a broker, when advising the buyers conceals the profitability of these product lines in such a way that the client would not be able to tell if they had been cheated. Third, integration encourages anti-competitive cross subsidy.\textsuperscript{206} Hence, what is probably needed in this case is an implemented code or policy, like the U.S.'s Securities Industry Association’s Code of Conduct, that cuts out any direct reporting line between research and corporate finance.\textsuperscript{207}

A crucial point in finding a motive for monitoring management can be originated if there is a conflict of interests between institutional investors and investment managers on one hand and management on the other hand. Institutional investors and investment managers were asked whether they believed that the interests of the board of directors differ from the interests of shareholders. Table 6.14 (Appendix I) shows that 81.5\% (if ignoring the missing answers) of institutional investors believed that the interests of the board of directors are different from the interests of shareholders and investment managers. Table 6.15 (Appendix I) illustrates that an even higher proportion of almost 93\% of investment managers believed that the interests of the board of directors are different from the interests of shareholders and investment managers.

There are many grounds on which the interests of the board of directors can differ from the interests of investment managers. The first and most obvious ground for a conflict of interests between holders of shares and management is management’s remuneration, bonuses, and contracts\textsuperscript{208}. The company’s financial performance and


\textsuperscript{207} ibid.

\textsuperscript{208} One investment manager stated ‘Self interest in respect of remuneration, bonuses, contracts.’ (investment manager’s questionnaire, control number 161). Another investment manager claimed ‘Ultimately directors to retain their jobs’ (investment managers’ questionnaire, control number 169).
time horizon are other grounds for such a conflict of interests.\textsuperscript{209} Moreover, takeovers, mergers and acquisitions can be considered as a potential ground for a conflict of interests between holders of shares and the company's management.\textsuperscript{210} Fourth, management might emphasise the interests of other corporate groups, such as employees and creditors, more than shareholders.\textsuperscript{211}

### 6.7. Summary and Conclusions

In summary, the questions addressed throughout this chapter were; should companies satisfy investors' expectations, ahead of formal announcements? Would the 'wink of an eye' by corporate managers to some investors, be considered as a breach of law? Is selective briefing necessary in lessening the volatility of share price? In conclusion, analysts might thrive on obtaining an information advantage, institutional investors normally opt to obtain privileged information by agreeing not to deal, and all, including small shareholders, would benefit if companies published more information, more frequently.

In the business world, cost is very important in deciding whether to carry out certain actions or not. Voluntary disclosure does cost money. However, the cost might be a bit overstated. The cost of communication with the market (mandatory and voluntary) might cost £200,000 to £300,000, in a medium to large public listed company, where the profit is one billion,\textsuperscript{212} which by all standards, should be considered as good value for money.

The business of the dissemination of information is a very tricky one. Private briefing is not without its merits to both companies and those investors that receive

\textsuperscript{209} One investment manager declared that: '[F]inancial performance + investment performance, plus time horizon' (investment manager's questionnaire, control number 168). Another investment manager said, 'Directors most focus on the performance of company. We are interested in the performance of the investment' (investment manager's questionnaire, control number 191).

\textsuperscript{210} One investment manager suggested: '[T]akeover, M&A [mergers and acquisitions], remuneration' as reasons, (investment manager's questionnaire, control number 222).

\textsuperscript{211} One investment managers stated that: 'not enough emphasis on generally shareholders value', (investment manager's questionnaire, control number 224).

\textsuperscript{212} J. Holland, 'Private Disclosure and Financial Reporting’, supra, n 2, 259.
the information and hence, gain an edge over the market. Tightening the rules of the stock market has to some extent, and may further result in exactly the opposite of what the F.S.A. intended (i.e. less disclosure). This is particularly the case in small to medium sized companies which are, in fact the very companies that would certainly benefit from higher profile coverage, rather than disappear into obscurity.\[213\] It is claimed that most of small to medium size companies cannot afford to spend resources on media and analysts’ conferences as big companies do. Hence, some small to medium size companies would be led into self-censorship.\[214\] On the other hand, ensuring fairness to all investors would boost public confidence in the stock market. This is particularly important, not only because public confidence is a pillar in any successful stock market, but also for satisfying the ever-increasing investment of private investors. The trend of private investors to invest in the stock market has rather speculatively been caused by the fact that it became practical to follow the price of one’s shares and sell and buy shares from one’s home via the Internet.\[215\] Moreover, there is the indirect link between private investors and the stock market, through insurance polices and pensions.

In an ideal world, ‘fair disclosure’ should encourage companies to open up and disclose more, rather than prompting them to clamp down on disclosure. The technology that we enjoy should make real-time financial reporting a reality. The problem though (as dangerous as it might be), is that regulations which are too restrictive might create a closer net of private briefing. Furthermore, the dissemination of information rules have resulted in more profit warnings,\[216\] which may lead to greater volatility in share price. Though, one could argue that is not really a problem if it results in a more transparent share price. However, it is needless to say that the response to profit warnings in the stock market is not

\[213\] A. Tan, supra, n 13.

\[214\] ibid.


\[216\] See, R. Rice, supra, n 113.
measured. For example, in 1994, the share prices of the Alfred McAlpine plc and First Choice holiday plc were significantly reduced after issuing profit warnings.\footnote{217}{See, A. FitzGerald, ‘Letters to the Editor: Pricing Problems in the Market’, (Financial Times, London, 5 October, 1995), 22.}

Yet, one must not perceive this as what Mr Adrian FitzGerald describes as, ‘fairness verses efficiency’.\footnote{218}{ibid.} This is because the market is not perfectly efficient, even after the prohibition of insider dealing and the introduction of the market dissemination of information rules.

It would seem that the legal armoury available to the F.S.A. and U.K.L.A. could be used to virtually eliminate the practice of private briefings if such a policy were considered desirable. However, given the importance of the role of the institutional investor in the corporate governance of listed companies and the Government’s policy of increased reliance on them in this role, it seems unlikely that the practice will be eliminated. It has been noted that specific price sensitive information must be disclosed to all or to none under the insider dealing rules and that the L.R. require disclosure of information likely to affect share price. However, the grey area of soft information is likely to remain one in which private briefings and dialogue can safely continue, so long as the role of the institution remains as important in corporate governance as it currently is.

As for institutional investors collective action, there is no doubt that stake building and concert party rules, to say the least, could make institutional investors think twice before taking positive action towards collectively try to monitor and control managers. Moreover, and at least according to those investment managers and institutional investors who participated in this study’s questionnaire, collective action does seem to exist for one to suggest that there established dialogue among intuitional investors and investment managers. In addition, and again at least among those investment managers and institutional investors who participated in this study’s questionnaire, there is no evidence of established dialogue between investors collectively and corporate managers behind closed doors. Hence, there is no doubt that dialogue in the U.K. is over regulated.


\footnote{218}{ibid.}

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Part Four
Chapter Seven

Conclusions and Overview

In *Norwest Holst Ltd v Secretary of State for Trade*,¹ LJ Denning, in the Court of Appeal, stated:

It sometimes happens that the public companies are conducted in a way which is beyond the control of the ordinary shareholders. The majority of the shares are in the hands of two or three individuals. They have control of the company’s affairs. The other shareholders know little and are told little. They receive the glossy annual reports. Most of them throw them into the wastepaper basket. There is an annual general meeting but few of the shareholders attend. The whole management and control is in the hands of the directors. They are a self-perpetuating oligarchy: and are virtually unaccountable. Seeing that the directors are the guardians of the company, the question is asked: Quis custodiet ipsos custodes -- who will guard the guards themselves?²

Since Denning’s statement in 1978, various internal and external methods have been implemented in an attempt to enhance the outdated existing corporate governance system in the U.K. Furthermore, the involvement of other stakeholders, in addition to shareholders has caused much debate. A range of studies, reports, reviews, etc, have been conducted in endeavouring to make corporate managers more accountable, including the accumulation of many reports in assembling the so-called ‘Code of Best Practice’. The conclusions of most of these studies, reports and reviews seem to agree that we must maintain the existing accountability system, depending on shareholders to conduct the monitoring of corporate managers and ensuring their accountability through the so-called ‘democracy system’ and various other routes.

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¹ [1978] 1 Ch.201.
² ibid., at 223. See also *Wallersteiner v Moir* [1974] 1 WLR 991.
Furthermore, there is no reason to believe that the existing accountability system, in which shareholders hold corporate managers accountable, will change any time soon at a legislative level. However, some companies may choose to involve other stakeholders in holding corporate managers accountable, particularly employees. This thesis was not primarily concerned by the compliance of corporations to the ‘Code of Best Practice’ amongst other codes and regulations, and how institutional investors could enforce such practices. Rather, in order to add value to corporations, this thesis concludes that institutional investors must have a clear agenda concerning their involvement in the corporate governance system.

The revival of shareholders’ role in holding corporate managers accountable was particularly supported by the tendency of institutional shareholders’ shareholding concentration in the L.S.E. The fact that institutional shareholders own more than 50% of listed companies would make it, at least theoretically possible, for them to formulate interest groups, which could gain factual control and hence, enabling them to monitor and control corporate managers. Though, the fact that investment managers manage a large amount of institutional investors and other investors’ equity in the L.S.E, also places them in a position where they could impel corporate managers to achieve better corporate governance and/or hold corporate managers to account. Thus, realistically, it is not shareholders’ role in general that should be revived as such; but rather, the involvement of institutional shareholders in the corporate governance system of the U.K.

This thesis examined whether or not the economic and legal frameworks of the market provide institutional investors and investment managers with the ability and hence, willingness, to achieve a sounder corporate governance system, by holding corporate managers to account. In light of these factors, this study presented demonstrative, rather than conclusive empirical evidence, collected from questionnaires distributed to institutional investors and investment managers that hold or manage equity in the L.S.E. In examining whether or not institutional investors are willing and able to hold corporate managers to account, the study went through three phases. In the first phase, the thesis scrutinised the U.K. corporate governance model, deducing that there are flaws in the
current U.K. corporate governance system, due to the fact that share ownership is so widely dispersed in U.K. public listed companies, it is impractical for shareholders to actually hold corporate managers to account.

External control through takeovers and mergers was an option for control in the U.K. for a short period of time in the 1980s, but soon faded. After the horrific privatisation era and the collapse of the market and scandals concerning certain companies in the late 1980s and early 1990s, two issues emerged; namely: the realisation of the need for a sound corporate governance system based on internal control; and, the phenomena of share ownership concentration in the hands of a few hundred institutional investors and investment managers. Hence, the option of an internal corporate governance model led by institutional investors was brought to the forefront.

This new approach to the internal corporate governance model was accompanied by other attempts to support it, in helping to achieve a sounder corporate governance system. For example, a series of reports on corporate governance best practices were initiated, commencing with the Cadbury Report. It was not long after the Cadbury Report that some corporate governance scholars, from all disciplines, began to advocate that institutional investors directly, or through investment managers, with the help of those reports on corporate governance best practices, could control the U.K.'s public listed companies. Of course, there has always been but a few active institutional investors in the market, attempting to change the corporate governance system for the better. Yet, this thesis alleges that there has never been an era in the U.K. where such a practice has been widespread.

There is no doubt that self-regulation and the 'Code of Best Practice' did and still continues to improve the corporate governance system. However, in order for self-regulation and the 'Code of Best Practice' to achieve its full potential, investors must be involved in corporate affairs, with the intention to change things for the better, and not simply take a box-ticking approach. One might suggest that the starting point towards achieving a good corporate governance system in the U.K. is to have meaningful
cooperation between the board of directors in general, and non-executive directors in particular, with shareholders generally, and institutional shareholders and investment managers in particular. For this to work, institutional shareholders/investment managers and non-executive directors should work together in monitoring and controlling corporate managers, towards achieving their accountability. Yet, initially, the independence of non-executive directors from executive directors must be somehow enforced, though not at the expense of keeping good and cooperative relations.

Moreover, the economic framework of the market surrounding institutional investors and investment managers was examined in phase one of this thesis, concluding that such a framework is not greatly promising in relation to holding corporate managers to account. In relation, it seems that there are many reasons which cause apathy among shareholders in monitoring and holding corporate managers to account. Among these reasons are: thin equity; diversification; liquidity of shares; reliance on other investors; apathy of shareholders’ agents; keeping access to soft information; conflict of interests; short termism; corporate managers’ manipulation of the general meeting’s agenda; and, investing in index funds. Collectively, these reasons must cause serious hindrance on investors’ willingness to monitor and control corporate managers in the U.K. Yet, there is no doubt that some investors might not be affected by these reasons, or indeed, might be affected by these reasons, but are still willing to monitor corporate managers, to achieve good corporate governance practices.

Whilst some institutional investors and investment managers may still be undeterred by these reasons in their desire to monitor and control corporate managers, one needed to examine whether the market’s legal framework offers such institutional investors and investment managers the support to hold corporate managers to account. The second and third phases of this thesis embarked on discovering if the legal framework of the market does indeed accomplish this. Specifically, chapter three of the thesis examined the underpinning theoretical framework of the legal role of shareholders in public listed companies. The three main dominating theories which have influenced the legislations are: corporation communitare; corporation concession; and corporation contractual
theories. Corporation communitaire theory views the corporation as a vehicle, which is supposed to further the welfare of society. Hence, shareholders’ ownership as a theme, does not exist; leaving shareholders in despair. Corporation concession theory on the other hand, takes a more reasonable stance in viewing shareholders’ role at the centre of companies. According to this theory, state intervention should be limited to maintaining the soundness of corporations as types of business medium. Corporation contractual theory, however, states that shareholders are the sole creators of corporations, leaving the self help remedy to shareholders to protect themselves against corporate controllers. The vagueness on the part of the British legislator in adopting one of these theories, as opposed to applying the three of them together, has left the legal position of shareholders in public listed companies somewhat in limbo.

Chapter three of this thesis also discussed the availability of contract negotiation between shareholders and corporate controllers as a means to control company management, in attempting to achieve a sound corporate governance system. Indeed, the legal framework of the U.K. supports the use of contract negotiation to provide more protective terms to a large extent. However, the empirical evidence, as presented in chapter three, showed little evidence of institutional investors and investment managers’ exploitation of such a means of protection.

Chapter four discussed the use of litigation as a means to holding corporate managers to account in the U.K., concluding that it almost virtually does not exist. Chapter five considered the effectiveness of the shareholder democracy system through voting in the G.M. and the use of proxies, concluding that although it is a means that is constantly improving, it still falls short as a method to holding corporate managers to account. Hence, the conclusion of phase two of this thesis was that, the traditional means as they stand today, do not offer the key to holding corporate managers to account. If institutional investors and investment managers are still undeterred by the economic and legal obstacles, they may resort to dialogue among themselves and with investment managers, as a means to holding corporate managers accountable. Yet, as exemplified in the third phase of this thesis, institutional investors and investment managers are over regulated
Part Four

Chapter 5

when it comes to both dialogue amongst themselves, as well as with corporate managers. Hence, neither the economic nor legal frameworks of the market offer the support to institutional investors and investment managers in holding corporate managers to account; leaving it to the extreme will and determination of shareholders to take initiatives in doing so; something that many institutional investors and investment managers may in fact, lack.

In relation to the above issues, the thesis can be concluded by the following analogy. When both the institutional investors and investment managers who participated in this study were asked whether they believed that institutional investors were in fact likely to become more active in participating in corporate governance issues in the future, both groups overwhelmingly predicted greater activism. Institutional investors and investment managers also adopted a similar stance when asked whether they believed institutional investors should become more active with respect to corporate governance, indicating that they thought this would be a positive step. The results suggest that the expectations and preferences of both groups may lean towards a greater constitutional role. Yet, in analysing these results in depth, one would be inclined to deduce that as far as the present situation is concerned, institutional investors and investment managers themselves, perhaps believe that they are not yet active participators in the corporate governance system; a problem which should be addressed with the utmost imminence, if we are ever truly to achieve a better corporate governance system in the U.K.

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3 See tables 7.1 and 7.2 (Appendix J).
4 See tables 7.3 and 7.4 (Appendix J).
5 See tables 7.1, 7.2, 7.3 and 7.4 (Appendix J).
Appendix A
Shareholders’ Legal Status in Public Listed companies
Institutional shareholders Survey

I am a law Ph.D. Researcher in the Faculty of Law at the University of Leicester. My research is on shareholders’ legal status in the companies listed on the Stock Exchange: namely, shareholders’ rights under the Companies Act and under Common Law in listed public companies.

This survey was assembled as part of a PhD thesis. The main purpose of the survey is to examine whether the legal system in England and Wales provides enough protection to shareholders in public listed companies. In particular, I am seeking information on your investment policy, monitoring policy, monitoring obstacles, policy when discontented with management and the availability of litigation. Your responses to this survey will remain anonymous, unless you choose to waive anonymity. The results of the survey will be part of a Ph.D. thesis and may be published in a scholarly legal article. If you wish to receive a copy of the survey’s results, when it is ready, please attach your business card to the completed survey. I hope this survey will prove useful to shareholders and will assist you and others in developing relevant policies. (You will remain anonymous even if you attach your business card, unless you waive your anonymity, in writing, at the end of the survey).

Thank you for participating in this survey. Please return it by 8th December 2000 using the self addressed prepaid envelope provided for your convenience. Send to: Ahmed Al-Hawamdeh Ph.D. Researcher Faculty of Law University of Leicester Leicester LE1 7RD

If you have any questions, please call me at 0116 215 5074, or fax to 0116 252 5023.

Note: If your organisation does not invest in UK shares, please tick here □ and return the survey.
If you invest in markets other than the UK please complete the form only in respect to UK investments.
Control Number ________ (Anonymity is guaranteed. The control number will be used solely to monitor the response rates.)
General Information:

1- Estimated market value of your institution’s assets as at the end of the last financial year £ ____________________

2- Estimated percentage of your institution’s assets invested in London Stock Exchange shares as at the end of the last financial year ___________________ %

3- Who has the responsibility of managing your shares portfolios?
   Please estimate the percentage of your institution’s equity portfolio dealt with in each of the following ways
   In house equity manager(s)__________________ %
   External equity manager(s) ________________ %
   Other: specify ___________________________ %

4- What source(s) of information do you rely on to make sure that the company’s memorandum and articles of association provide the usual protections and recommendations in the codes of best practice developed by the ‘Combined Code’? Please tick as appropriate
   The Company’s memorandum and articles of association2 □
   Information provided in accordance with stock exchange or statutory requirements3 □
   Financial reports in the newspapers or any type of media □
   NAPF or other associations’ reports □
   Market research sources, such as “Jordan’s Data Quest” □
   Others: specify □ ____________________________

   If your institution relies on more than one source of information, what is the main one?

5- Do you invest in index funds? Yes □  No □

1. The Combined code is: a code published in 1998 by The Committee of Corporate Governance combining the recommendations of Cadbury, Greenbury and Hampel Committees of corporate governance issues

2. Or other constitutional documents (e.g. charter and certificate of incorporation in the USA)

3. Company’s Annual Report or listing particulars for a share issue.
The relationship between investors and their external equity manager agent(s):

6- Does your institution employ external equity manager(s) at all tick?
Yes ☐ No (go to question 8) ☐

7- On average, how often does your institution discuss corporate performance with your external equity manager(s)?
   Monthly ☐ Quarterly ☐ Once every six months ☐
   Annually ☐ On ad hoc basis ☐ Never ☐
   Other: specify ☐

8- Do you believe that the interests of external investment managers differ from the interests of shareholders?
   Yes, they differ significantly ☐ Yes, they differ slightly ☐
   No, they do not differ (go to question 11) ☐
   Comment: ____________________________________________

9- On what types of issues do the interests of external investment managers differ from the interests of shareholders?
   _______________________________________________________

10- Do you have any suggestions for making the interests of external investment managers and shareholders differ less?
   _______________________________________________________

The relationship between shareholders:

11- On average, how often does your institution discuss corporate performance with other shareholder(s) in the companies in which you both hold shares?
   Monthly ☐ Quarterly ☐ Once every six months ☐
   Annually ☐ On ad hoc basis ☐ Never, (go to question 13) ☐
   Other, specify ☐

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12- Which of the following categories of shareholders does your institution discuss with the company's performance? Shareholders were classified on the basis of the proportion of the shares that they hold, then subdivided into three types within each of the two categories. (Please tick as appropriate)

<table>
<thead>
<tr>
<th>Shareholders with a holding of 3% or more</th>
<th>Shareholders with a holding less than 3%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Institutional shareholders</td>
<td>Institutional shareholders</td>
</tr>
<tr>
<td>Corporate shareholders</td>
<td>Corporate shareholders</td>
</tr>
<tr>
<td>Individual shareholders</td>
<td>Individual shareholders</td>
</tr>
</tbody>
</table>

Other shareholders: specify □ ____________________________

The relationship between institutional investors and company's management:

13- On average, how often does your institution discuss corporate performance with the management of a company in which you hold shares?

<table>
<thead>
<tr>
<th>Frequency</th>
</tr>
</thead>
<tbody>
<tr>
<td>Monthly</td>
</tr>
<tr>
<td>Quarterly</td>
</tr>
<tr>
<td>Once every six months</td>
</tr>
<tr>
<td>Annually</td>
</tr>
<tr>
<td>On ad hoc basis</td>
</tr>
<tr>
<td>Never</td>
</tr>
</tbody>
</table>

Other, specify □ ____________________________

14- In your experience, does the management of a company consult investment managers or shareholders with significant holdings of 3% or more to obtain prior consent for large transactions that do not require shareholders' approval, such as an acquisition? Yes □ No □ Not sure □

Comment: _____________________________________________

15- Do you believe that the interests of the board of directors differ from the interests of shareholders? Yes, they differ significantly □ Yes, they differ slightly □ No, they do not differ (go to question 18) □

Comment: _____________________________________________
16- On what types of issues do the interests of the board of directors differ from the interests of shareholders? ________________________

17- Do you have any suggestions for making the interests of the board of directors and shareholders differ less? ______________________________________________

Hypotheses for apathy in monitoring management

18- Do you expect investment managers and shareholders with significant holdings of 3% or more in the company to monitor and if necessary seek to take an action against management? Yes □ No □ Not sure □
Comment: ______________________________________________

19- Do you think thin equity (i.e. when the holding is less than 3%) might be a reason for investment managers’ and shareholders’ inactivity in monitoring companies’ management? Yes □ No □ Not sure □
Comment: ______________________________________________

20- Do you think that diversification of investment might be a reason for investment managers’ and shareholders’ inactivity in monitoring companies’ management? Yes □ No □ Not sure □
Comment: ______________________________________________

21- Do you think that liquidity of shares (i.e. not being committed to keep holding the shares in a company) might be a reason for investment managers’ and shareholders’ inactivity in monitoring companies’ management? Yes □ No □ Not sure □
Comment: ______________________________________________
22- Do you think that reliance on other shareholders or investment managers might be a reason for investment managers' and shareholders' inactivity in monitoring companies' management? Yes □ No □ Not sure □

Comment: ________________________________

23- Do you think that the apathy of shareholders' agents might be a reason for inactive monitoring of corporate performance? Yes □ No □ Not sure □

Comment: ________________________________

24- Do you think keeping access to soft information through friendly relations with management might be a reason for inactive monitoring of corporate performance? Yes □ No □ Not sure □

Comment: ________________________________

25- Do you think that conflicts of interest, such as the fear that insurance companies or banks may lose their business with the company in which they have shareholdings, might be a reason for shareholders' inactivity in monitoring the company's management? Yes □ No □ Not sure □

Comment: ________________________________

26- Do you think that comparison with other investment managers' performance and market indices might be a reason for inactivity in monitoring companies' management? Yes □ No □ Not sure □

Comment: ________________________________

27- Do you think that short-term investment might be a reason for investment managers' and shareholders' inactivity in monitoring management? Yes □ No □ Not sure □

Comment: ________________________________
28- Do you think that management manipulation of the general meeting agenda might be a reason for inactive monitoring of management? Yes ☐ No ☐ Not sure ☐
Comment: __________________________________________

29- Do you think that political retaliation might be a reason for investment managers' and shareholders' inactivity in monitoring management? Yes ☐ No ☐ Not sure ☐
Comment: __________________________________________

30- Do you believe that investing in index funds rather than directly in shares affects the investor's ability to influence corporate governance? Yes ☐ No ☐ Not sure ☐
Comment: __________________________________________

31- Do you have any reason, which is not mentioned above for inactive monitoring of management? Yes ☐ No ☐
If yes what is it: ________________________________________

32- How often does a shareholder with a holding of 3% or more have the option of exiting the company without great loss if they are dissatisfied with management? Frequently ☐ Occasionally ☐ Rarely ☐ Never ☐
Comment: __________________________________________

Shareholders' conflict of interests:

33- Do you believe the interests of institutional shareholders differ from the interests of individual shareholders? Yes, they differ significantly ☐ Yes, they differ slightly ☐
No, they do not differ (go to question 36) ☐
Comment: __________________________________________
34- On what types of issues do the interests of institutional shareholders differ from the interests of individual shareholders? ___________________________________________

35- Do you have any suggestions for making the interests of institutional shareholders and individual shareholders differ less? ___________________________________________

36- Do you believe that monitoring and influencing company management by institutional shareholders' managers has sometimes caused conflicts of interest and conflicts of loyalty between the institution's beneficiaries and the company's other shareholders? Yes □ No, go to question 38 □ Not sure □
Comment: ___________________________________________

37- Do you have any suggestion for ways of avoiding this type of conflict of interest?
Comment: ___________________________________________

Actions when dissatisfied with management:

38- What action would your institution take when dissatisfied with the company's performance? Please, rank in order of importance (i.e. 1 = most important, 7 = least important)

Sell shares □
Discuss with management □
Discuss with non-executive directors □
Try to encourage take-over of the company □
Form a coalition with other shareholders to take action □
Commence litigation □
Other: specify □ ____________________________
Comment: ___________________________________________
39- If your institution is dissatisfied with management regarding an issue where litigation is available, would you consider using litigation or involving lawyers?
Yes □ No □ Not sure □

Comment: ________________________________

If no is it because of: Please, tick as appropriate
The high cost of legal actions □ Time consuming □
The risk of retaliation by management □ Bad publicity □
The effect on the share price of the company □ The lack of clarity in laws □

Others: please specify □ ________________________________

Comment: ________________________________

Voting and proxies:

40- Does your institution have standard proxy voting guidelines? Yes □ No □

41- Does your institution delegate any of your voting proxies to your external equity manager(s)? Yes □ No (go to question 47) □

42- Does your institution have sufficient staff and resources to check whether your external investment manager(s) vote proxies, according to your proxy voting guidelines? Yes □ No □

43- Has your institution asked an external investment manager, which you delegated proxy voting authority, to vote contrary to the proxy voting guidelines?
Yes □ No □ Not sure □

If yes, describe the types of issues about which your institution asked your external investment manager(s) to vote contrary to their proxy voting guidelines ______________

______________________________
44- Has your institution ever voiced any sort of disagreement with a proxy voting decision made by your external investment manager(s)?
   Yes □  No □  Not sure □

   If yes, describe the types of issues about which disagreement occurred and what action, if any, your institution took as a result of that? _________________________

45- Has your institution ever asked your external investment manager(s) to return your voting proxies? Yes □  No □  Not sure □

   If yes, explain __________________________________________________________

46- Has your institution ever disciplined an external investment manager(s) because of their refusal to vote proxies as directed? Yes □  No □  Not sure □

   If yes, explain __________________________________________________________

47- Does your firm manage any equity portfolio in-house?  
   Yes □  No (go to question 53) □

48- How often has your institution proposed a resolution at a company general meeting? Frequently □  Occasionally □  Rarely □  Never (go to question 50) □

49- How often does management meet with your institution to negotiate a settlement when your institution has requested a meeting or proposed a resolution?  
   Frequently □  Occasionally □  Rarely □  Never □

50- Does your institution have a systematic practice for checking on management casting your proxy vote as you instructed? Yes □  No □

   If yes what is it: __________________________________________________________

51- Do you believe that your institution has sufficient staff and resources to monitor whether management fulfil your proxy voting guidelines? _________________________
52- How often does your institution vote contrary to the board’s recommendations?
Frequently □  Occasionally □  Rarely □  Never □

Comment: ________________________________________________________________

53- Has your institution ever sold your shareholdings in a company because of management’s refusal to act upon your recommendations?
Frequently □  Occasionally □  Rarely □  Never □

Comment: ________________________________________________________________

54- Do you believe that institutional investors will become more active with respect to corporate governance in the next ten years? Yes □  No □  Not sure □

Comment: ________________________________________________________________

55- Do you believe that institutional investors should become more active with respect to corporate governance? Yes □  No □  Not sure □

If no why: __________________________________________________________________

Your answers will remain anonymous, unless you waive your anonymity by providing the following information

<table>
<thead>
<tr>
<th>Name of the Institution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Your Name</td>
</tr>
<tr>
<td>Your job title</td>
</tr>
</tbody>
</table>

Final Comment: ________________________________________________________________

________________________________________  

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Appendix B
Shareholders' Legal Status in Public Listed companies
Investment Managers Survey

I am a law Ph.D. Researcher in the Faculty of Law at the University of Leicester. My research is on shareholders' legal status in the companies listed on the Stock Exchange: namely, shareholders' rights under the Companies Act and under Common Law in listed public companies.

This survey was assembled as part of a PhD thesis. The main purpose of the survey is to examine whether the legal system in England and Wales provides enough protection to shareholders in public listed companies. Given the fact that investment managers manage a large proportion of shares listed on the London Stock Exchange, I am seeking information on your investment policy, monitoring policy, monitoring obstacles, policy when discontented with management and the availability of litigation. Your responses to this survey will remain anonymous, unless you choose to waive anonymity. The results of the survey will be part of a Ph.D. thesis and may be published in a scholarly legal article. If you wish to receive a copy of the survey's results, when it is ready, please attach your business card to the completed survey. I hope this survey will prove useful to shareholders and will assist you and others in developing relevant policies. (You will remain anonymous even if you attach your business card, unless you waive your anonymity, in writing, at the end of the survey).

Thank you for participating in this survey. Please return it by 8th December 2000 using the self addressed prepaid envelope provided for your convenience. Send to:
Ahmed Al-Hawamdeh
Ph.D. Researcher
Faculty of Law
University of Leicester
University Road
Leicester LE1 7RD

If you have any questions, please call me at 0116 215 5074, or fax to 0116 252 5023.

Note: If your firm does not invest or manage UK shares, please tick here □ and return the survey.
If your firm invests in markets other than the UK please complete the form only in respect to UK investments.

Control Number ________ (Anonymity is guaranteed. The control number will be used solely to monitor the response rates.)

-276-
General information:

1- How many institutional investors, such as pension funds and insurance companies does your firm act for? _______________________

2- Estimated market value of equity portfolios that your firm manages for institutional investors as at the last financial year _______________________

3- How many of your firm's institutional investor clients invest in index funds? _______________________

4- How many private investors does your firm act for? ___________________________

5- Estimated market value of equity portfolios that your firm manages for private investors as at the last financial year _______________________

6- How many of your firm's private investor clients invest in index funds? _______________________

7- What source(s) of information does your firm rely on to make sure that the company's memorandum and articles of association provide the usual protections and recommendations in the codes of best practice developed by the 'Combined Code'? Please, tick as appropriate

   - The company's memorandum and articles of association
   - Information provided in accordance with stock exchange / statutory requirements
   - Financial reports in the newspapers or any type of media
   - NAPF or other associations' reports
   - Market research sources, such as "Jordan's Data Quest"

   Others: specify □ _______________________

If your firm relies on more than one source of information, what is the main one? _______________________

1. The Combined code is: a code published in 1998 by The Committee of Corporate Governance combing the recommendations of Cadbury, Greenbury and Hampel Committees of corporate governance issues

2. Or other constitutional documents (e.g. charter and certificate of incorporation in the USA)

3. Company's Annual Report or listing particulars for a share issue.
The relationship between investment managers and their shareholder clients:

8- On average, how often does your firm discuss corporate performance with your shareholder clients in companies in which you manage investments?
   - Monthly □
   - Quarterly □
   - Once every six months □
   - Annually □
   - On ad hoc basis □
   - Never (go to question 10) □
Other: specify □ _______________________________________

9- Which of the following categories of shareholders does your firm discuss with the company’s performance? Shareholders were classified on the basis of the proportion of the shares that they hold, then subdivided into three types within each of the two categories. (Please tick as appropriate)

<table>
<thead>
<tr>
<th>Shareholders with a holding of 3% or more</th>
<th>Shareholders with a holding less than 3%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Institutional shareholders □</td>
<td>Institutional shareholders □</td>
</tr>
<tr>
<td>Corporate shareholders □</td>
<td>Corporate shareholders □</td>
</tr>
<tr>
<td>Individual shareholders □</td>
<td>Individual shareholders □</td>
</tr>
</tbody>
</table>

Other shareholders: specify □ _____________________________

10- Do you believe that the interests of shareholders differ from the interests of investment managers? Yes, they differ significantly □
    Yes, they differ slightly □
    No, they do not differ (go to question 13) □
Comment: ____________________________________________

11- On what types of issues do the interests of shareholders differ from the interests of investment managers? ________________________________________________

12- Do you have any suggestions for making the interests of shareholders and investment managers differ less? ________________________________________________

The relationship between investment managers

13- On average, how often does your firm discuss corporate performance with other investment manager(s) of a company in which you both manage investments?
   - Monthly □
   - Quarterly □
   - Once every six months □
   - Annually □
   - Never □
   - On ad hoc basis □
Other: specify □ _______________________________________

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The relationship between investment manager and company’s management:

14- On average, how often does your firm discuss corporate performance with the management of a company in which you hold or manage shares?
- Monthly □
- Quarterly □
- Once every six months □
- Annually □
- Never □
- On ad hoc basis □
- Other: specify □ ________________

15- Do you believe that the interests of the board of directors differ from the interests of investment managers? Yes, they differ significantly □
- Yes, they differ slightly □
- No, they do not differ (go to question 18) □
- Comment: ____________________________________________

16- On what types of issues do the interests of the board of directors differ from the interests of investment managers?
__________________________________________________________

17- Do you have any suggestions for making the interests of the board of directors and investment managers differ less?
__________________________________________________________

18- In your experience does the management of a company consult investment managers or shareholders with significant holdings of 3% or more to obtain prior consent for large transactions that do not require shareholders’ approval, such as an acquisition?
- Yes □
- No □
- Not sure □
- Comment: ____________________________________________

Hypotheses for apathy in monitoring management:

19- Do you expect investment managers and shareholders with significant holdings of 3% or more in the company to monitor and if necessary seek to take an action against management? Yes □
- No □
- Not sure □
- Comment: ____________________________________________
20. Do you think equity (i.e. when the holding is less than 3%) might be a reason for investment managers' and shareholders' inactivity in monitoring companies' management? Yes □ No □ Not sure □
Comment: ____________________________________________________________

21. Do you think that diversification of investment might be a reason for investment managers' and shareholders' inactivity in monitoring companies' management? Yes □ No □ Not sure □
Comment: ____________________________________________________________

22. Do you think that liquidity of shares (i.e. not being committed to keep holding the shares in a company) might be a reason for investment managers' and shareholders' inactivity in monitoring companies' management? Yes □ No □ Not sure □
Comment: ____________________________________________________________

23. Do you think that reliance on other shareholders or investment managers might be a reason for inactivity in monitoring companies' management? Yes □ No □ Not sure □
Comment: ____________________________________________________________

24. Do you think that the apathy of shareholders' agents might be a reason for inactive monitoring of corporate performance? Yes □ No □ Not sure □
Comment: ____________________________________________________________

25. Do you think keeping access to soft information through friendly relations with management might be a reason for inactive monitoring of corporate performance? Yes □ No □ Not sure □
Comment: ____________________________________________________________
26- Do you think that comparison with other investment managers' performance and market indices might be a reason for inactivity in monitoring companies' management? Yes □  No □  Not sure □

Comment: ____________________________________________________________

27- Do you think that conflicts of interest, such as the fear that insurance companies or banks may lose their business with the company in which they have shareholdings, might be a reason for shareholders' inactivity in monitoring the company's management? Yes □  No □  Not sure □

Comment: ____________________________________________________________

28- Do you think that short-term investment might be a reason for inactive monitoring of management? Yes □  No □  Not sure □

Comment: ____________________________________________________________

29- Do you think that management manipulation of the general meeting agenda might be a reason for inactive monitoring of management? Yes □  No □  Not sure □

Comment: ____________________________________________________________

30- Do you think that political retaliation might be a reason for investment managers' and shareholders' inactivity in monitoring management? Yes □  No □  Not sure □

Comment: ____________________________________________________________

31- Do you believe that investing in index funds rather than directly in shares affects the investor's ability to influence corporate governance? Yes □  No □  Not sure □

Comment: ____________________________________________________________
32- Do you have any reason, which is not mentioned above for inactive monitoring of management? Yes □ No □

If yes what is it: ______________________________________

33- How often does a shareholder with a holding of 3% or more have the option of exiting the company without great loss if they are dissatisfied with management?

Frequently □ Occasionally □ Rarely □ Never □

Comment: ______________________________________

34- Do you believe that institutional investors should meet with management to discuss corporate performance? Yes □ No □ Not sure □

If no, why ______________________________________

Shareholders’ conflict of interests:

35- How far do you think institutional shareholders’ monitoring of management is valuable to other shareholders?

Very valuable □ Quite valuable □
Not very valuable □ Not at all valuable □

Comment: ______________________________________

36- Do you believe the interests of institutional shareholders differ from the interests of individual shareholders?

Yes, they differ significantly □ Yes, they differ slightly □
No, they do not differ (go to question 39) □

Comment: ______________________________________

37- On what types of issues do the interests of institutional shareholders differ from the interests of individual shareholders? ______________________________________

____________________________________
38- Do you have any suggestions for making the interests of institutional shareholders and individual shareholders differ less? 

______________________________

39- Do you believe that monitoring and influencing company management by institutional shareholders' managers has sometimes caused conflicts of interest and conflicts of loyalty between the institution's beneficiaries and the company's other shareholders? Yes ☐ No, go to question 41 ☐ Not sure ☐

Comment: ________________________________________________________

______________________________

40- Do you have any suggestion for ways of avoiding this type of conflict of interest?

______________________________________________________________

Actions when dissatisfied with management:

41- What action would your firm take or advise your client to take when dissatisfied with the company's performance? Please, rank in order of importance (i.e. 1 = most important, 7 = least important)

☐ Sell shares
☐ Discuss with management
☐ Discuss with non-executive directors
☐ Try to encourage take-over of the company
☐ Commence litigation
☐ Form a coalition with other shareholders to take action

Other: please specify ☐ __________________________________________________________________

Comment: ________________________________________________________

______________________________

42- If your firm is dissatisfied with management regarding an issue where litigation is available, would you consider using or advising your client to use litigation or involving lawyers? Yes, go to question 44 ☐ No ☐ Not sure ☐

Comment: ________________________________________________________

______________________________
43- If no is it because of: Please, tick as appropriate

- The high cost of legal actions☐ Time consuming☐
- The risk of retaliation by management☐ Bad publicity☐
- The effect on the share price of the company☐ The lack of clarity in laws☐

Others: please specify☐ ________________________________

Comment:_________________________________________________________

Voting and proxies:

44- Does your firm have standard proxy voting guidelines? Yes☐ No☐

45- How many of your firm’s institutional investor clients have delegated proxy voting authority to your firm? ________________________________

46- How many of your firm’s private investor clients have delegated proxy voting authority to your firm? ________________________________

47- Does your firm have sufficient staff and resources to vote proxies according to proxy voting guidelines of your investor clients? Yes☐ No☐ Sometimes on certain circumstances or agreement☐

48- Has your firm ever been asked by an investor client, which delegated proxy voting authority to your firm to vote contrary to the proxy voting guidelines? Frequently☐ Occasionally☐ Rarely☐ Never (go to question 50)☐

49- Describe the types of issues about which your investor clients have asked you to vote contrary to your proxy voting guidelines ________________________________

50- Have any of your clients voiced disagreement with a proxy voting decision made by your firm? Yes☐ No☐ Not sure☐

If yes, describe the types of issues on which disagreement occurred and what action, if any, your firm took as a result of that? ________________________________

51- Have any of your clients ever asked you to return their voting proxies to them to vote? Yes☐ No☐ Not sure☐

If yes, explain: ______________________________________________________
52- Have you ever lost a client because your firm refused to vote proxies as directed?  
Yes □  No □  Not sure □  
If yes, explain: ________________________________________________________________  
..............................................................................................................................  

53- How often does your firm exercise your voting rights and proxies?  
Always □  Frequently □  Occasionally □  Rarely □  Never □  

54- Has your firm ever proposed a resolution at a company general meeting?  
Frequently □  Occasionally □  Rarely □  Never □  

55- How often does management meet with your firm to negotiate a settlement when you  
have requested a meeting or proposed a resolution?  
Frequently □  Occasionally □  Rarely □  Never □  

56- Does your firm give equal consideration to your use of proxies in all companies in  
which you manage or hold shares? Yes □  No □  Not sure □  
If no explain: ________________________________________________________________  
..............................................................................................................................  

57- Does your firm have a systematic practice for checking on management casting your  
proxy vote as you instructed? Yes □  No □  sometimes □  
Comment: .................................................................................................................  
........................................................................................................................................  

58- Do you believe that your firm has sufficient staff and resources to monitor whether  
management fulfill your proxy voting guidelines? Yes □  No □  
Comment: .................................................................................................................  
........................................................................................................................................  

59- Has your firm ever sold or advised your client to sell shareholdings in a company  
because of a management refusal to act upon your recommendations?  
Frequently □  Occasionally □  Rarely □  Never □  
Comment: .................................................................................................................  
........................................................................................................................................  

60- Has your firm ever represented a corporation and institutional investor client,  
which intended to vote its proxy against that corporation management?  
Frequently □  Occasionally □  Rarely □  Never (go to question 63) □  

- 285 -
61- Do you think that this placed your firm in a conflict of interests?
Yes ☐ No ☐ Not sure ☐

62- If yes, do you have any suggestion for ways of avoiding this type of conflict of interests?
________________________________________________________________________

63- Do you believe that institutional investors will become more active with respect to corporate governance? Yes ☐ No ☐ Not sure ☐

Comment: ________________________________________________________________
________________________________________________________________________

64- Do you believe that institutional investors should become more active with respect to corporate governance? Yes ☐ No ☐ Not sure ☐

If no why: __________________________________________________________________
________________________________________________________________________

Your answers will remain anonymous, unless you waive your anonymity by providing the following information

<table>
<thead>
<tr>
<th>Name of the Institution</th>
<th></th>
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</thead>
<tbody>
<tr>
<td>Your Name</td>
<td></td>
</tr>
<tr>
<td>Your job title</td>
<td></td>
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</table>

Final comment: ________________________________________________________________
________________________________________________________________________
________________________________________________________________________
________________________________________________________________________
Appendix C
Subject: Questionnaire enquiry

I sent a letter on the 13th of November 2000 together with a questionnaire entitled Shareholders Legal Status in Public Listed Companies. The questionnaire concerned your relations as an investor with the companies in which you hold shares and not the position of your own company. Thus, whether or not your own company is a PLC, you can complete the questionnaire if you hold shares in any UK listed PLC.

If you have already sent the questionnaire back then please ignore this reminder. However, if you have not, I would be grateful if you could complete it and return it, in the self addressed prepaid envelope attached to it, as soon as possible.

Your participation in the questionnaire will be very important in providing an accurate picture of shareholders’ legal status in public listed companies. I expect the results of the questionnaire to be ready by March 2001. If you wish to receive a copy of the questionnaire’s results, please attach your business card to the completed questionnaire. You will remain anonymous unless you waive anonymity in writing at the end of the survey.

Please, do not hesitate to contact me if you have any queries regarding the questionnaire.

I wait in anticipation of a favourable response.

Respectfully yours
Appendence D
Subject: Questionnaire enquiry

I sent a letter on the 13th of November 2000 together with a questionnaire entitled *Shareholders Legal Status in Public Listed Companies*. The questionnaire concerned your relations as an investment manager with the companies in which you manage or hold shares and not the position of your own company. Thus, whether or not your own company is a PLC, you can complete the questionnaire if you manage or hold shares in any UK listed PLCs.

If you have already sent the questionnaire back then please ignore this reminder. However, if you have not, I would be grateful if you could complete it and return it, in the self addressed pre paid envelope attached to it, as soon as possible.

Your participation in the questionnaire will be very important in providing an accurate picture of shareholders' legal status in public listed companies. I expect the results of the questionnaire to be ready by March 2001. If you wish to receive a copy of the questionnaire's results, please attach your business card to the completed questionnaire. You will remain anonymous unless you waive anonymity in writing at the end of the survey.

Please, do not hesitate to contact me if you have any queries regarding the questionnaire.

I wait in anticipation of a favourable response.

Respectfully yours
Appendence E
### Table 1.2
**INSTITUTIONAL INVESTORS RESPONSE RATE**

<table>
<thead>
<tr>
<th>Response Description</th>
<th>Frequency</th>
<th>Per cent</th>
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</thead>
<tbody>
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<td>73.4</td>
</tr>
<tr>
<td>Completed the questionnaire (responded)</td>
<td>102</td>
<td>11.8</td>
</tr>
<tr>
<td>Do not invest in L.S.E. (responded)</td>
<td>39</td>
<td>4.5</td>
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<tr>
<td>Returned the questionnaire uncompleted (responded)</td>
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### Table 1.3
**INVESTMENT MANAGERS RESPONSE RATE**

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### Table 2.1
Institutional investors' table of the frequency of selling shares without great loss when dissatisfied with corporate managers

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<tr>
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<tr>
<td>Rarely</td>
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### Table 2.2
Investment managers' table of the frequency of selling shares without great loss when dissatisfied with corporate managers

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<tr>
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<td>Rarely</td>
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Table 2.3
Institutional investors' table on thin equity and its effects on inactivity in monitoring companies' managers

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Table 2.4
Investment managers' table on thin equity and its effects on inactivity in monitoring corporations and their managers

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### Table 2.5
Institutional investors' table on liquidity of shares and inactivity in monitoring corporations and their managers

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### Table 2.6
Investment managers’ table on liquidity of shares and inactivity in monitoring corporations and their managers

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### Table 2.7
Institutional investors' table on diversification and inactivity in monitoring corporate managers

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### Table 2.8
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Table 2.9
Institutional investors’ table on reliance on others and in activity in monitoring corporate managers

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Table 2.10
Investment managers’ table on reliance on others and in activity in monitoring corporate managers

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### Table 2.11
Institutional investors’ table on comparison with other investors and inactivity in monitoring companies’ managers

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### Table 2.12
Investment managers’ table on comparison with other investors and inactivity in monitoring companies’ managers

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### Table 2.13
Institutional investors’ table on agent apathy as a reason for inactivity in monitoring corporate managers

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### Table 2.14
Investment managers’ table on agent apathy as a reason for inactivity in monitoring corporate managers

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### Table 2.15
Institutional investors' table on the demand for soft information and its influence on inactivity in monitoring corporate managers

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### Table 2.16
Investment managers' table on the demand for soft information and its influence on inactivity in monitoring corporate managers

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Table 2.17
Institutional investors' table on conflicts of interest and inactivity in monitoring corporate managers

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Table 2.18
Investment managers’ table on conflicts of interest and inactivity in monitoring corporate managers

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### Table 2.19
Institutional investors' table on short termism and apathy in monitoring corporate managers

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### Table 2.20
Investment managers' table on short termism and apathy in monitoring corporate managers

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### Table 2.21
Institutional investors' table on corporate managers manipulation of the general meeting agenda and inactivity in monitoring corporate managers

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<td>102</td>
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</tbody>
</table>

### Table 2.22
Investment managers' table on corporate managers manipulation of the general meeting agenda and inactivity in monitoring corporate managers

<table>
<thead>
<tr>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>2</td>
</tr>
<tr>
<td>No</td>
<td>11</td>
</tr>
<tr>
<td>Not sure</td>
<td>1</td>
</tr>
<tr>
<td>Total</td>
<td>14</td>
</tr>
</tbody>
</table>
### Table 2.23
Institutional investors’ table on political retaliation and inactivity in monitoring corporate managers

<table>
<thead>
<tr>
<th></th>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>3</td>
<td>2.9</td>
</tr>
<tr>
<td>No</td>
<td>76</td>
<td>74.5</td>
</tr>
<tr>
<td>Not sure</td>
<td>22</td>
<td>21.6</td>
</tr>
<tr>
<td>Total</td>
<td>101</td>
<td>99.0</td>
</tr>
<tr>
<td>Missing</td>
<td>1</td>
<td>1.0</td>
</tr>
<tr>
<td>Total</td>
<td>102</td>
<td>100.0</td>
</tr>
</tbody>
</table>

### Table 2.24
Investment managers’ table on political retaliation and inactivity in monitoring corporate managers

<table>
<thead>
<tr>
<th></th>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>2</td>
<td>14.3</td>
</tr>
<tr>
<td>No</td>
<td>11</td>
<td>78.6</td>
</tr>
<tr>
<td>Not sure</td>
<td>1</td>
<td>7.1</td>
</tr>
<tr>
<td>Total</td>
<td>14</td>
<td>100.0</td>
</tr>
</tbody>
</table>
### Table 2.25
Index funds and the investors’ ability to influence corporate governance

<table>
<thead>
<tr>
<th></th>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>60</td>
<td>58.8</td>
</tr>
<tr>
<td>No</td>
<td>25</td>
<td>24.5</td>
</tr>
<tr>
<td>Not sure</td>
<td>16</td>
<td>15.7</td>
</tr>
<tr>
<td>Total</td>
<td>101</td>
<td>99.0</td>
</tr>
<tr>
<td>Missing</td>
<td>1</td>
<td>1.0</td>
</tr>
<tr>
<td>Total</td>
<td>102</td>
<td>100.0</td>
</tr>
</tbody>
</table>

### Table 2.26
Index funds and the investors’ ability to influence corporate governance

<table>
<thead>
<tr>
<th></th>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>8</td>
<td>57.1</td>
</tr>
<tr>
<td>No</td>
<td>5</td>
<td>35.7</td>
</tr>
<tr>
<td>Not sure</td>
<td>1</td>
<td>7.1</td>
</tr>
<tr>
<td>Total</td>
<td>14</td>
<td>100.0</td>
</tr>
</tbody>
</table>
Appendix G
### Table 4.1

What action would your firm take or advise your client to take when dissatisfied with the company's performance?

<table>
<thead>
<tr>
<th>Action</th>
<th>Sell shares</th>
<th>Discuss with management</th>
<th>Discuss with non-executive directors</th>
<th>Try to encourage take-over of the company</th>
<th>Commence litigation</th>
<th>Form a coalition with other shareholders</th>
<th>Commence litigation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number</td>
<td>14</td>
<td>14</td>
<td>14</td>
<td>14</td>
<td>14</td>
<td>14</td>
<td>14</td>
</tr>
<tr>
<td>Mean</td>
<td>6.2857</td>
<td>5.7143</td>
<td>4.1429</td>
<td>2.4286</td>
<td>1.7143</td>
<td>2.3571</td>
<td></td>
</tr>
<tr>
<td>Median</td>
<td>7.0000</td>
<td>6.0000</td>
<td>5.0000</td>
<td>2.5000</td>
<td>1.0000</td>
<td>1.5000</td>
<td></td>
</tr>
</tbody>
</table>

### Table 4.2

What action would your institution take when dissatisfied with the company's performance?

<table>
<thead>
<tr>
<th>Action</th>
<th>Sell shares</th>
<th>Discuss with management</th>
<th>Discuss with non-executive directors</th>
<th>Try to encourage take-over of the company</th>
<th>Commence litigation</th>
<th>Form a coalition with other shareholders</th>
<th>Commence litigation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Mean</td>
<td>3.9300</td>
<td>3.8600</td>
<td>3.1200</td>
<td>1.4200</td>
<td>2.1900</td>
<td>.7900</td>
<td></td>
</tr>
<tr>
<td>Median</td>
<td>5.0000</td>
<td>6.0000</td>
<td>4.0000</td>
<td>.0000</td>
<td>1.0000</td>
<td>.0000</td>
<td></td>
</tr>
</tbody>
</table>
### Table 4.3
If your institution is dissatisfied with management regarding an issue where litigation is available, would you consider using litigation or involving lawyers?

<table>
<thead>
<tr>
<th></th>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>7</td>
<td>6.9</td>
</tr>
<tr>
<td>No</td>
<td>46</td>
<td>45.1</td>
</tr>
<tr>
<td>Not sure</td>
<td>36</td>
<td>35.3</td>
</tr>
<tr>
<td>Total</td>
<td>89</td>
<td>87.3</td>
</tr>
<tr>
<td>Missing</td>
<td>13</td>
<td>12.7</td>
</tr>
<tr>
<td>Total</td>
<td>102</td>
<td>100.0</td>
</tr>
</tbody>
</table>

### Table 4.4
If your firm is dissatisfied with management regarding an issue where litigation is available, would you consider using or advising your client to use litigation or involving lawyers?

<table>
<thead>
<tr>
<th></th>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>3</td>
<td>21.4</td>
</tr>
<tr>
<td>No</td>
<td>10</td>
<td>71.4</td>
</tr>
<tr>
<td>Not sure</td>
<td>1</td>
<td>7.1</td>
</tr>
<tr>
<td>Total</td>
<td>14</td>
<td>100.0</td>
</tr>
</tbody>
</table>
Table 4.5
Reasons that result to institutional investors and investment managers not to use litigation and involving lawyers regarding an issue where litigation is available

<table>
<thead>
<tr>
<th>Reason</th>
<th>Institutional Investors %</th>
<th>Investment Managers %</th>
</tr>
</thead>
<tbody>
<tr>
<td>High Cost of Legal Action</td>
<td>35.3%</td>
<td>64.3%</td>
</tr>
<tr>
<td>Risk of Management</td>
<td>2%</td>
<td>7.1%</td>
</tr>
<tr>
<td>Retaliation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Effect on Company Share</td>
<td>9.8%</td>
<td>35.7%</td>
</tr>
<tr>
<td>Price</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Time Consuming Nature of Process</td>
<td>29.4%</td>
<td>57.1%</td>
</tr>
<tr>
<td>Bad Publicity</td>
<td>10.8%</td>
<td>35.7%</td>
</tr>
<tr>
<td>Lack of Clarity in Laws</td>
<td>3.9%</td>
<td>21.4%</td>
</tr>
</tbody>
</table>
Appendix H
Table 5.1 (Institutional Investors Survey)

<table>
<thead>
<tr>
<th>Does your institution delegate any of your voting proxies to your external equity manager(s)?</th>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>73</td>
<td>71.6</td>
</tr>
<tr>
<td>No</td>
<td>24</td>
<td>23.5</td>
</tr>
<tr>
<td>Total</td>
<td>97</td>
<td>95.1</td>
</tr>
<tr>
<td>Missing</td>
<td>5</td>
<td>4.9</td>
</tr>
<tr>
<td>Total</td>
<td>102</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Table 5.2 (Institutional investors survey)

<table>
<thead>
<tr>
<th>Does your institution have standard proxy voting guidelines?</th>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>81</td>
<td>79.4</td>
</tr>
<tr>
<td>No</td>
<td>18</td>
<td>17.6</td>
</tr>
<tr>
<td>Total</td>
<td>99</td>
<td>97.1</td>
</tr>
<tr>
<td>Missing</td>
<td>3</td>
<td>2.9</td>
</tr>
<tr>
<td>Total</td>
<td>102</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Table 5.3 (Investment managers survey)

<table>
<thead>
<tr>
<th>Does your firm have standard proxy voting guidelines?</th>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>14</td>
<td>100.0</td>
</tr>
<tr>
<td>No</td>
<td>0</td>
<td>0.0</td>
</tr>
<tr>
<td>Total</td>
<td>14</td>
<td>100.0</td>
</tr>
</tbody>
</table>
Table 5.4 (Institutional Investors Survey)
Does your institution have sufficient staff and resources to check whether your external equity manager(s) vote proxies, according to your proxy voting guidelines?

<table>
<thead>
<tr>
<th></th>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>21</td>
<td>26.6</td>
</tr>
<tr>
<td>No</td>
<td>48</td>
<td>60.7</td>
</tr>
<tr>
<td>Total</td>
<td>69</td>
<td>87.3</td>
</tr>
<tr>
<td>Missing</td>
<td>10</td>
<td>12.7</td>
</tr>
<tr>
<td>Total</td>
<td>79</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Table 5.5 (Investment managers Survey)
Does your firm have sufficient staff and resources to vote proxies according to proxy voting guidelines of your investor clients?

<table>
<thead>
<tr>
<th></th>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>9</td>
<td>64.3</td>
</tr>
<tr>
<td>No</td>
<td>2</td>
<td>14.3</td>
</tr>
<tr>
<td>Sometimes on certain circumstances or agreement</td>
<td>3</td>
<td>21.4</td>
</tr>
<tr>
<td>Total</td>
<td>14</td>
<td>100.0</td>
</tr>
</tbody>
</table>
### Table 5.6 (Institutional investors Survey)

Has your institution asked an external investment manager(s), which you delegated proxy voting authority, to vote contrary to the proxy voting guidelines?\(^1\)

<table>
<thead>
<tr>
<th></th>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>7</td>
<td>8.9</td>
</tr>
<tr>
<td>No</td>
<td>54</td>
<td>68.4</td>
</tr>
<tr>
<td>Not Sure</td>
<td>8</td>
<td>10.1</td>
</tr>
<tr>
<td>Total</td>
<td>69</td>
<td>87.3</td>
</tr>
<tr>
<td>Missing</td>
<td>10</td>
<td>9.8</td>
</tr>
<tr>
<td>Total</td>
<td>79</td>
<td>100.0</td>
</tr>
</tbody>
</table>

\(^1\) Note here, that this question was not applicable to 23 of the institutional investors who participated in the study, as they do not have any interest in managing their own investments.

### Table 5.7 (Investment Managers Survey)

Has your firm ever been asked by an investor client, which delegated proxy voting authority to your firm to vote contrary to the proxy voting guidelines?

<table>
<thead>
<tr>
<th></th>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Frequently</td>
<td>0</td>
<td>0.0</td>
</tr>
<tr>
<td>Occasionally</td>
<td>5</td>
<td>35.7</td>
</tr>
<tr>
<td>Rarely</td>
<td>5</td>
<td>35.7</td>
</tr>
<tr>
<td>Never</td>
<td>4</td>
<td>28.6</td>
</tr>
<tr>
<td>Total</td>
<td>14</td>
<td>100.0</td>
</tr>
</tbody>
</table>
Table 5.8 (Institutional Investors Survey)
Has your institution ever voiced any sort of disagreement with a proxy voting decision made by your external investment manager(s)?

<table>
<thead>
<tr>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>4</td>
</tr>
<tr>
<td>No</td>
<td>61</td>
</tr>
<tr>
<td>Not Sure</td>
<td>5</td>
</tr>
<tr>
<td>Total</td>
<td>70</td>
</tr>
<tr>
<td>Missing</td>
<td>9</td>
</tr>
<tr>
<td>Total</td>
<td>79</td>
</tr>
</tbody>
</table>

Table 5.9 (Investment Managers Survey)
Have any of your clients voiced disagreement with a proxy voting decision made by your firm?

<table>
<thead>
<tr>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>0</td>
</tr>
<tr>
<td>No</td>
<td>11</td>
</tr>
<tr>
<td>Not Sure</td>
<td>3</td>
</tr>
<tr>
<td>Total</td>
<td>14</td>
</tr>
</tbody>
</table>

2 Note here, that this question was not applicable to 23 of the institutional investor respondents, as they do not have any interest in managing their own investments.
Table 5.10 (Institutional Investors Survey)

Has your institution ever asked your external investment manager(s) to return your voting proxies?³

<table>
<thead>
<tr>
<th>Frequency</th>
<th>Per cent</th>
<th>Valid per cent</th>
<th>Cumulative per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>1</td>
<td>1.2</td>
<td>1.4</td>
</tr>
<tr>
<td>No</td>
<td>66</td>
<td>83.5</td>
<td>94.3</td>
</tr>
<tr>
<td>Not Sure</td>
<td>3</td>
<td>3.8</td>
<td>4.3</td>
</tr>
<tr>
<td>Total</td>
<td>70</td>
<td>88.6</td>
<td>100.0</td>
</tr>
<tr>
<td>Missing</td>
<td>9</td>
<td>11.4</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>79</td>
<td>100.0</td>
<td></td>
</tr>
</tbody>
</table>

Table 5.11 (Institutional investors)

Has your institution ever disciplined an external investment manager(s) because of their refusal to vote proxies as directed?⁴

<table>
<thead>
<tr>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>0</td>
</tr>
<tr>
<td>No</td>
<td>70</td>
</tr>
<tr>
<td>Total</td>
<td>70</td>
</tr>
<tr>
<td>Missing</td>
<td>9</td>
</tr>
<tr>
<td>Total</td>
<td>79</td>
</tr>
</tbody>
</table>

Table 5.12 (Investment managers survey)

Have you ever lost a client because your firm refused to vote proxies as directed?

<table>
<thead>
<tr>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>0</td>
</tr>
<tr>
<td>No</td>
<td>14</td>
</tr>
</tbody>
</table>

³ Note here, that this question was not applicable to 23 of the institutional investor respondents, as they do not have any interest in managing their own investments.

⁴ Note here, that this question was not applicable to 23 of the institutional investor respondents, as they do not have any interest in managing their own investments.
### Table 5.13 (Investment managers survey)
How often does your firm exercise your voting rights and proxies?

<table>
<thead>
<tr>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Always</td>
<td>8</td>
</tr>
<tr>
<td>Frequently</td>
<td>3</td>
</tr>
<tr>
<td>Occasionally</td>
<td>2</td>
</tr>
<tr>
<td>Rarely</td>
<td>1</td>
</tr>
<tr>
<td>Total</td>
<td>14</td>
</tr>
</tbody>
</table>
### Table 5.14 (Institutional investors Survey)
How often has your institution proposed a resolution at a company general meeting?

<table>
<thead>
<tr>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Frequently</td>
<td>0</td>
</tr>
<tr>
<td>Occasionally</td>
<td>3</td>
</tr>
<tr>
<td>Rarely</td>
<td>6</td>
</tr>
<tr>
<td>Never</td>
<td>17</td>
</tr>
<tr>
<td>Total</td>
<td>26</td>
</tr>
<tr>
<td>Missing</td>
<td>4</td>
</tr>
<tr>
<td>Total</td>
<td>30</td>
</tr>
</tbody>
</table>

### Table 5.15 (Investment managers survey)
Has your firm ever proposed a resolution at a company G.M.?

<table>
<thead>
<tr>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Frequently</td>
<td>0</td>
</tr>
<tr>
<td>Occasionally</td>
<td>0.0</td>
</tr>
<tr>
<td>Rarely</td>
<td>5</td>
</tr>
<tr>
<td>Never</td>
<td>9</td>
</tr>
<tr>
<td>Total</td>
<td>14</td>
</tr>
</tbody>
</table>
### Table 5.16 (Institutional investors Survey)
How often does management meet with your institution to negotiate a settlement when your institution has requested a meeting or proposed a resolution?

<table>
<thead>
<tr>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Frequently</td>
<td>2</td>
</tr>
<tr>
<td>Occasionally</td>
<td>3</td>
</tr>
<tr>
<td>Rarely</td>
<td>2</td>
</tr>
<tr>
<td>Never</td>
<td>2</td>
</tr>
<tr>
<td>Total</td>
<td>9</td>
</tr>
</tbody>
</table>

### Table 5.17 (Investment managers survey)
How often does management meet with your firm to negotiate a settlement when you have requested a meeting or proposed a resolution?

<table>
<thead>
<tr>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Frequently</td>
<td>3</td>
</tr>
<tr>
<td>Occasionally</td>
<td>1</td>
</tr>
<tr>
<td>Rarely</td>
<td>3</td>
</tr>
<tr>
<td>Never</td>
<td>2</td>
</tr>
<tr>
<td>Total</td>
<td>9</td>
</tr>
<tr>
<td>Missing</td>
<td>1</td>
</tr>
<tr>
<td>Total</td>
<td>10</td>
</tr>
</tbody>
</table>
Table 5.18 (Institutional investors Survey)

Does your institution have a systematic practice for checking on management casting your proxy vote as you instructed?

<table>
<thead>
<tr>
<th></th>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>8</td>
<td>26.7</td>
</tr>
<tr>
<td>No</td>
<td>16</td>
<td>53.3</td>
</tr>
<tr>
<td>Total</td>
<td>24</td>
<td>80.0</td>
</tr>
<tr>
<td>Missing</td>
<td>6</td>
<td>20.0</td>
</tr>
<tr>
<td>Total</td>
<td>30</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Table 5.19 (Investment managers survey)

Does your firm have a systematic practice for checking on management casting your proxy vote as you instructed?

<table>
<thead>
<tr>
<th></th>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>5</td>
<td>35.7</td>
</tr>
<tr>
<td>No</td>
<td>8</td>
<td>57.1</td>
</tr>
<tr>
<td>Total</td>
<td>13</td>
<td>92.9</td>
</tr>
<tr>
<td>Missing</td>
<td>1</td>
<td>7.1</td>
</tr>
<tr>
<td>Total</td>
<td>14</td>
<td>100.0</td>
</tr>
</tbody>
</table>
**Table 5.20 (Institutional investors Survey)**

Has your institution ever sold shareholdings in a company because of a management refusal to act upon your recommendations?

<table>
<thead>
<tr>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Frequently</td>
<td>1</td>
</tr>
<tr>
<td>Occasionally</td>
<td>12</td>
</tr>
<tr>
<td>Rarely</td>
<td>18</td>
</tr>
<tr>
<td>Never</td>
<td>59</td>
</tr>
<tr>
<td>Total</td>
<td>90</td>
</tr>
<tr>
<td>Missing</td>
<td>12</td>
</tr>
<tr>
<td>Total</td>
<td>102</td>
</tr>
</tbody>
</table>

**Table 5.21 (Investment managers survey)**

Has your firm ever sold or advised your client to sell shareholdings in a company because of a management refusal to act upon your recommendations?

<table>
<thead>
<tr>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Frequently</td>
<td>0</td>
</tr>
<tr>
<td>Occasionally</td>
<td>3</td>
</tr>
<tr>
<td>Rarely</td>
<td>5</td>
</tr>
<tr>
<td>Never</td>
<td>6</td>
</tr>
<tr>
<td>Total</td>
<td>14</td>
</tr>
</tbody>
</table>
Appendix I
Table 6.1 (Investment Managers Survey)

Do you believe that institutional investors should meet with management to discuss corporate performance?

<table>
<thead>
<tr>
<th></th>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>12</td>
<td>85.7</td>
</tr>
<tr>
<td>No</td>
<td>1</td>
<td>7.1</td>
</tr>
<tr>
<td>Total</td>
<td>13</td>
<td>92.9</td>
</tr>
<tr>
<td>Missing System</td>
<td>1</td>
<td>7.1</td>
</tr>
<tr>
<td>Total</td>
<td>14</td>
<td>100.0</td>
</tr>
</tbody>
</table>
Table 6.2 (Institutional Investors Survey)

On average, how often does your Institution discuss corporate performance with the management of a company in which you hold shares?

<table>
<thead>
<tr>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Quarterly</td>
<td>1</td>
</tr>
<tr>
<td>Once every six months</td>
<td>6</td>
</tr>
<tr>
<td>Annually</td>
<td>7</td>
</tr>
<tr>
<td>On ad hoc basis</td>
<td>14</td>
</tr>
<tr>
<td>Never</td>
<td>64</td>
</tr>
<tr>
<td>Other</td>
<td>3</td>
</tr>
<tr>
<td>Total</td>
<td>95</td>
</tr>
<tr>
<td>Missing System</td>
<td>7</td>
</tr>
<tr>
<td>Total</td>
<td>102</td>
</tr>
</tbody>
</table>

Table 6.3 (Investment Managers Survey)

On average, how often does your firm discuss corporate performance with the management of a company in which you hold or manage shares?

<table>
<thead>
<tr>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Quarterly</td>
<td>0</td>
</tr>
<tr>
<td>Once every six months</td>
<td>6</td>
</tr>
<tr>
<td>Annually</td>
<td>3</td>
</tr>
<tr>
<td>On ad hoc basis</td>
<td>1</td>
</tr>
<tr>
<td>Never</td>
<td>4</td>
</tr>
<tr>
<td>Other</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>14</td>
</tr>
</tbody>
</table>
### Table 6.4 (Institutional Investors Survey)

In your experience, does the management of a company consult investment managers or shareholders with significant holdings of 3% or more to obtain prior consent for large transactions that do not require shareholders' approval, such as an acquisition?

<table>
<thead>
<tr>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>28</td>
</tr>
<tr>
<td>No</td>
<td>15</td>
</tr>
<tr>
<td>Not sure</td>
<td>44</td>
</tr>
<tr>
<td>Total</td>
<td>87</td>
</tr>
<tr>
<td>Missing</td>
<td>15</td>
</tr>
<tr>
<td>Total</td>
<td>102</td>
</tr>
</tbody>
</table>

### Table 6.5 (Investment Managers Survey)

In your experience does the management of a company consult investment managers or shareholders with significant holdings of 3% or more to obtain prior consent for large transactions that do not require shareholders' approval, such as an acquisition?

<table>
<thead>
<tr>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>8</td>
</tr>
<tr>
<td>No</td>
<td>0</td>
</tr>
<tr>
<td>Not sure</td>
<td>4</td>
</tr>
<tr>
<td>Total</td>
<td>12</td>
</tr>
<tr>
<td>Missing</td>
<td>2</td>
</tr>
<tr>
<td>Total</td>
<td>14</td>
</tr>
</tbody>
</table>
Table 6.6 (Institutional Investors Survey)
On average, how often does your institution discuss corporate performance with other shareholder(s) in the companies in which you both hold shares?

<table>
<thead>
<tr>
<th>Valid</th>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Monthly</td>
<td>2</td>
<td>2.0</td>
</tr>
<tr>
<td>Quarterly</td>
<td>5</td>
<td>4.9</td>
</tr>
<tr>
<td>Annually</td>
<td>1</td>
<td>1.0</td>
</tr>
<tr>
<td>On ad hoc basis</td>
<td>15</td>
<td>14.7</td>
</tr>
<tr>
<td>Never</td>
<td>75</td>
<td>73.5</td>
</tr>
<tr>
<td>Other</td>
<td>3</td>
<td>2.9</td>
</tr>
<tr>
<td>Total</td>
<td>101</td>
<td>99.0</td>
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<tr>
<td>Missing System</td>
<td>1</td>
<td>1.0</td>
</tr>
<tr>
<td>Total</td>
<td>102</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Table 6.7 (Institutional Investors Survey)
The type of shareholders that investors might discuss corporate performance with

<table>
<thead>
<tr>
<th>Institutional shareholders</th>
<th>Corporate shareholders</th>
<th>Individual shareholders</th>
<th>Institutional shareholders less than 3%</th>
<th>Corporate shareholders less than 3%</th>
<th>Individual shareholders less than 3%</th>
</tr>
</thead>
<tbody>
<tr>
<td>3% or more</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td>20</td>
</tr>
<tr>
<td>Valid</td>
<td>Number</td>
<td>Number</td>
<td>Missing</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>4</td>
<td>0</td>
</tr>
</tbody>
</table>
### Table 6.8 (Institutional Investors Questionnaire)

On average, how often does your institution discuss corporate performance with your external equity managers?

<table>
<thead>
<tr>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Monthly</td>
<td>8</td>
</tr>
<tr>
<td>Quarterly</td>
<td>44</td>
</tr>
<tr>
<td>Once every six months</td>
<td>17</td>
</tr>
<tr>
<td>Annually</td>
<td>3</td>
</tr>
<tr>
<td>On ad hoc basis</td>
<td>6</td>
</tr>
<tr>
<td>Never</td>
<td>3</td>
</tr>
<tr>
<td>Other</td>
<td>3</td>
</tr>
<tr>
<td>Total</td>
<td>84</td>
</tr>
<tr>
<td>Missing System</td>
<td>18</td>
</tr>
<tr>
<td>Total</td>
<td>102</td>
</tr>
</tbody>
</table>

### Table 6.9 (Investment Managers Questionnaire)

On average, how often does your firm discuss corporate performance with your shareholder clients in companies in which you manage investments?

<table>
<thead>
<tr>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Monthly</td>
<td>1</td>
</tr>
<tr>
<td>Quarterly</td>
<td>6</td>
</tr>
<tr>
<td>Once every six months</td>
<td>1</td>
</tr>
<tr>
<td>Annually</td>
<td>1</td>
</tr>
<tr>
<td>On ad hoc basis</td>
<td>1</td>
</tr>
<tr>
<td>Never</td>
<td>4</td>
</tr>
<tr>
<td>Total</td>
<td>14</td>
</tr>
</tbody>
</table>
Table 6.10 (Investment Managers Questionnaire)
The type of shareholders that investors might discuss corporate performance with

<table>
<thead>
<tr>
<th></th>
<th>Institutional shareholders</th>
<th>Corporate shareholders</th>
<th>Individual shareholders</th>
<th>Institutional shareholders</th>
<th>Corporate shareholders</th>
<th>Individual shareholders</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>3% or more</td>
<td>3% or more</td>
<td>3% or more</td>
<td>less than 3%</td>
<td>less than 3%</td>
<td>less than 3%</td>
</tr>
<tr>
<td>Number</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>Valid</td>
<td>Yes</td>
<td>0</td>
<td>1</td>
<td>6</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>No</td>
<td>4</td>
<td>10</td>
<td>9</td>
<td>4</td>
<td>10</td>
</tr>
</tbody>
</table>

Table 6.11 (Investment Managers Questionnaire)
On average, how often does your firm discuss corporate performance with other investment manager(s) of a company in which you both manage investments?

<table>
<thead>
<tr>
<th>Valid</th>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Monthly</td>
<td>0</td>
<td>0.0</td>
</tr>
<tr>
<td>Quarterly</td>
<td>1</td>
<td>7.1</td>
</tr>
<tr>
<td>Once every six months</td>
<td>0</td>
<td>0.0</td>
</tr>
<tr>
<td>Annually</td>
<td>0</td>
<td>0.0</td>
</tr>
<tr>
<td>On ad hoc basis</td>
<td>5</td>
<td>35.7</td>
</tr>
<tr>
<td>Never</td>
<td>7</td>
<td>50.0</td>
</tr>
<tr>
<td>Total</td>
<td>13</td>
<td>92.9</td>
</tr>
<tr>
<td>Missing System</td>
<td>1</td>
<td>7.1</td>
</tr>
<tr>
<td>Total</td>
<td>14</td>
<td>100.0</td>
</tr>
</tbody>
</table>
Table 6.12 (Institutional Investors Questionnaire)
Do you believe that the interests of shareholders differ from the interests of investment managers?

<table>
<thead>
<tr>
<th></th>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes, they differ significantly</td>
<td>18</td>
<td>17.6</td>
</tr>
<tr>
<td>Yes, they differ slightly</td>
<td>41</td>
<td>40.2</td>
</tr>
<tr>
<td>No, they do not differ</td>
<td>41</td>
<td>40.2</td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
<td>98.0</td>
</tr>
<tr>
<td>Missing system</td>
<td>2</td>
<td>2.0</td>
</tr>
<tr>
<td>Total</td>
<td>102</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Table 6.13 (Investment Managers Questionnaire)
Do you believe that the interests of shareholders differ from the interests of investment managers?

<table>
<thead>
<tr>
<th></th>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes, they differ significantly</td>
<td>0</td>
<td>0.0</td>
</tr>
<tr>
<td>Yes, they differ slightly</td>
<td>4</td>
<td>28.6</td>
</tr>
<tr>
<td>No, they do not differ</td>
<td>10</td>
<td>71.4</td>
</tr>
<tr>
<td>Total</td>
<td>14</td>
<td>100.0</td>
</tr>
</tbody>
</table>
Table 6.14 (Institutional Investors Questionnaire)
Do you believe that the interests of the board of directors differ from the interests of shareholders?

<table>
<thead>
<tr>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes, they differ significantly</td>
<td>27</td>
</tr>
<tr>
<td>Yes, they differ slightly</td>
<td>48</td>
</tr>
<tr>
<td>No, they do not differ</td>
<td>17</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>92</strong></td>
</tr>
<tr>
<td>Missing System</td>
<td>10</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>102</strong></td>
</tr>
</tbody>
</table>

Table 6.15 (Investment Managers Questionnaire)
Do you believe that the interests of the board of directors differ from the interests of investment managers?

<table>
<thead>
<tr>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes, they differ significantly</td>
<td>8</td>
</tr>
<tr>
<td>Yes, they differ slightly</td>
<td>5</td>
</tr>
<tr>
<td>No, they do not differ</td>
<td>1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>14</strong></td>
</tr>
</tbody>
</table>
### Table 7.1 (institutional investors)

Do you believe that institutional investors will become more active with respect to corporate governance?

<table>
<thead>
<tr>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>82</td>
</tr>
<tr>
<td>No</td>
<td>6</td>
</tr>
<tr>
<td>Not sure</td>
<td>12</td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
</tr>
<tr>
<td>Missing</td>
<td>2</td>
</tr>
<tr>
<td>Total</td>
<td>102</td>
</tr>
</tbody>
</table>

### Table 7.2 (investment managers)

Do you believe that institutional investors will become more active with respect to corporate governance?

<table>
<thead>
<tr>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>12</td>
</tr>
<tr>
<td>Not sure</td>
<td>1</td>
</tr>
<tr>
<td>Total</td>
<td>13</td>
</tr>
<tr>
<td>Missing</td>
<td>1</td>
</tr>
<tr>
<td>Total</td>
<td>14</td>
</tr>
</tbody>
</table>
Table 7.3 (institutional investors)
Do you believe that institutional investors should become more active with respect to corporate governance?

<table>
<thead>
<tr>
<th></th>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>76</td>
<td>74.5</td>
</tr>
<tr>
<td>No</td>
<td>7</td>
<td>6.9</td>
</tr>
<tr>
<td>Not sure</td>
<td>17</td>
<td>16.7</td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
<td>98.0</td>
</tr>
<tr>
<td>Missing</td>
<td>2</td>
<td>2.0</td>
</tr>
<tr>
<td>Total</td>
<td>102</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Table 7.4 (investment managers)
Do you believe that institutional investors should become more active with respect to corporate governance?

<table>
<thead>
<tr>
<th></th>
<th>Frequency</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>12</td>
<td>85.7</td>
</tr>
<tr>
<td>No</td>
<td>1</td>
<td>7.1</td>
</tr>
<tr>
<td>Not sure</td>
<td>1</td>
<td>7.1</td>
</tr>
<tr>
<td>Total</td>
<td>14</td>
<td>100.0</td>
</tr>
</tbody>
</table>
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