Background note

Institutional investors' engagement in Latin America

2023 OECD-Latin America Roundtable
on Corporate Governance

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1. Introduction

The G20/OECD Principles of Corporate Governance (G20/OECD Principles) states that the "corporate governance framework should facilitate and support institutional investors' engagement with their investee companies" (OECD, 2023[1]). Institutional investors include a variety of capital markets participants, such as mutual funds, pension funds, insurance companies, hedge funds, and index funds. Institutional investors are legal entities, institutions, or vehicles that professionally aggregate and manage final investors' assets (OECD, 2013[2]). The proper understanding of institutional investors is essential (Celik and Isaksson, 2013[3]) given that this category of investor has acquired a prominent role in capital markets, both globally and in Latin America.

In recent years, some institutional investors have undertaken actions aiming at promoting good corporate governance, such as (i) efforts to enhance engagement with investee companies, in particular about themes related to environmental, social and governance issues[1]; (ii) the strengthening of stewardship codes around the world; (iii) the empowerment of internal stewardship departments within asset management companies; and (iv) an increased focus on the transparency of voting policies and voting records (OECD, 2011[4]; Fukami, Blume and Magnusson, 2022[5]).

As outlined in the OECD Corporate Governance Factbook 2023 (OECD, 2023[6]), there are still challenges in various jurisdictions that inhibit the engagement of institutional investors on a more consistent basis. Hence, the objective of this background note is to present examples of those issues, correspondent reactions, and possible solutions in Latin America.

Section 2 aims to provide an overview of the latest trends and major concerns in capital markets that involve institutional investors' participation, with particular attention to the corporate governance implications in Latin America. Specifically, sections 2.1 and 2.2 focus on asset managers, indicating some of the consequences of the combination between the amount of assets under management, the concentration of these resources within a small number of investment companies, and the passive investment strategy followed by some of them. Section 2.3 delves into findings concerning how sustainability-related issues have been addressed by institutional investors. Section 2.4 describes the role of stewardship codes as a complementary mechanism to support institutional investors engaging with investee companies.

There are different types of institutional investors and business models, and each one presents its challenges related to corporate governance practices. Moreover, each jurisdiction has its own distinct characteristics, which should be considered when analysing policy alternatives. Furthermore, the respective stage of development of domestic capital markets should also be considered when assessing alternative approaches.

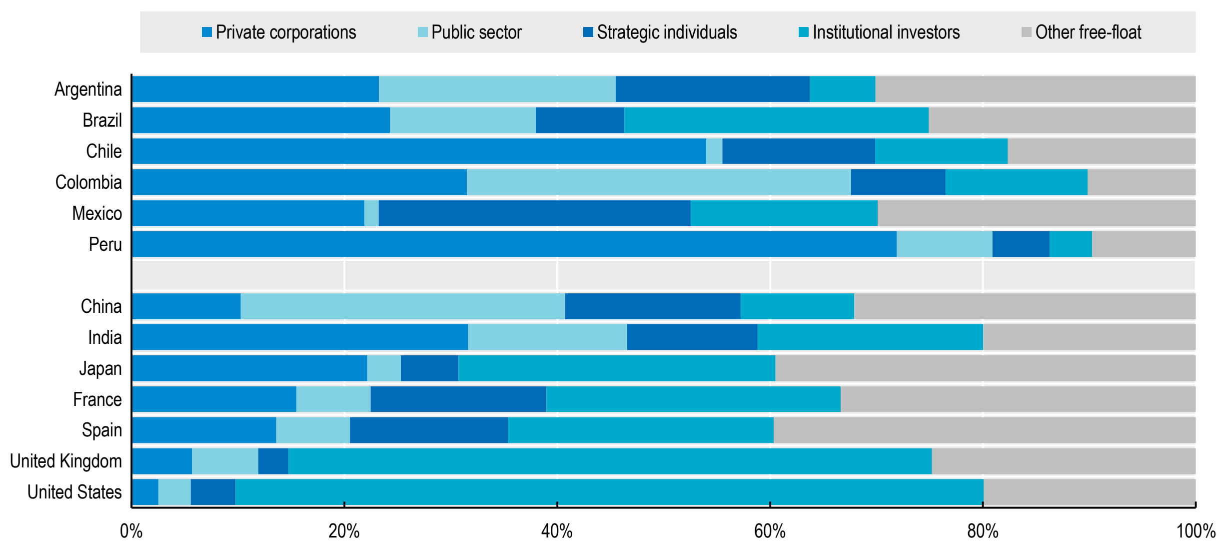
2. Trends and key issues

2.1 Institutional ownership

By the end of 2022, there were nearly 44 000 public companies worldwide, with a total market capitalisation of USD 98 trillion (OECD, 2023[6]). The United States has the largest capital market in the world by market capitalisation, while Asia has the highest number of listed companies. Latin America still represents a small portion of this total, but there is a growing significance of emerging markets in the global landscape. There are several explanations for the comparative growth of emerging markets, including the fact that in jurisdictions with more developed capital markets companies have remained private for longer periods, as well as the expansion of private equity funds (Coates, 2023[7]).

Over the past few decades, the global share of the listed equity held by institutional investors has grown remarkably. In 2022, their holdings amounted to 44% of the listed equity (OECD, 2023[6]). In the United States and the United Kingdom, institutional investors hold 70% and 60% of the listed companies' equity, respectively. In Japan, France and Spain, institutional investors rank also first among different categories of investors, with a comparatively lower share of market capitalisation. In India and in most Latin American countries, private corporations are the most prominent investors. Private corporations rank first in Peru (holding 72% of the listed equity) and in Chile (54%), while in Colombia the public sector holds 36% of the listed equity. Figure 1 below shows the ownership distribution among different categories of owners for the selected regions, using the categories in the report *Owners of the World's Listed Companies* (De La Cruz, Medina and Tang, 2019[8]).

Figure 1. Investor holdings at country level, end-2022

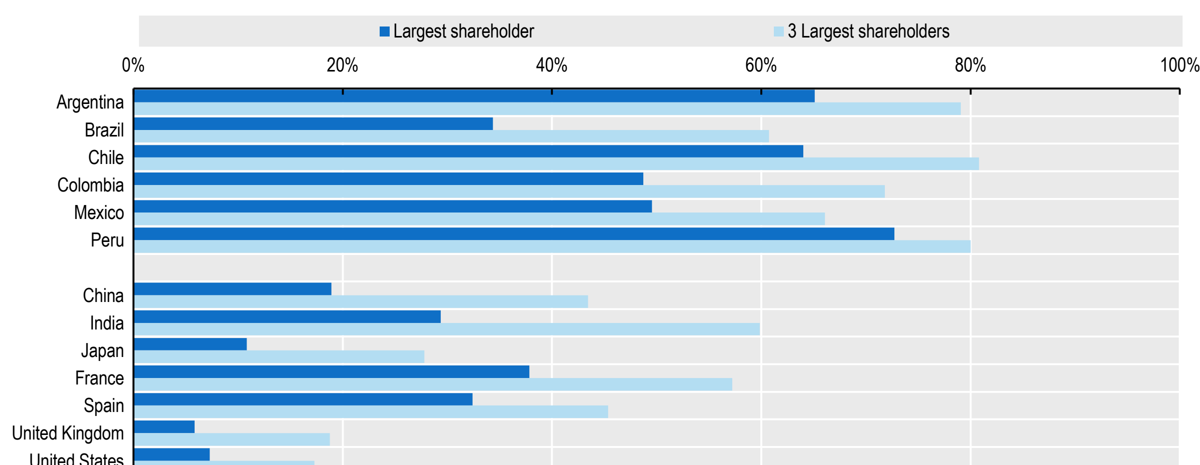


Note: "Other free-float" refers to the holdings by shareholders that do not reach the threshold for mandatory disclosure of their ownership records or retail investors that are not required to do so.
Source: OECD Capital Market Series dataset, FactSet, LSEG, Bloomberg.

In Latin America, institutional investors hold 21% of the listed equity. Although it is still a lower share than in developed markets, it underscores the consistent growth of institutional investors in the region. In 2022, institutional investors held 29% of the market capitalisation of listed companies in Brazil, making them the main category of investors in the largest Latin American capital market.

In addition to the relevance of institutional investors, the ownership structure of listed companies is becoming progressively concentrated globally. This is particularly prominent in Latin American markets where at least 60% of all listed companies in each market have three owners holding more than 50% of the equity capital (Figure 2).

Figure 2. Ownership concentration by market, end 2022



Note: The figure presents the share of companies where the largest and three largest shareholder(s) hold more than 50% of the equity as share of the total number of listed companies in each market.
Source: OECD Capital Market Series dataset, FactSet, LSEG, Bloomberg.

In an already concentrated environment dominated by large companies (OECD, 2021[9]), the absenteeism of a significant part of the shareholders could lead to negative outcomes (Fukami, Blume and Magnusson, 2022[5]). This situation might contribute to poor corporate governance and harm the interests of shareholders and stakeholders.

2.2 Institutional investment strategies

There are various investment strategies adopted by major asset managers. Specific formats exist in which greater engagement is an intrinsic part of the investment strategy, so a more active participation may be an inherent fiduciary duty of the asset manager. However, passive investment strategies – e.g. tracking specific indices – of institutional investors are gaining more attention from a corporate governance standpoint. This is because they comprise a significant portion of institutional investors and do not have a strong incentive or obligation to engage effectively with portfolio companies.

Asset managers following a passive investment strategy have expanded their services globally and in Latin America, providing investors interested in leveraging the increasing specialisation of third-party services to manage their wealth. By using technology and offering competitive fees (Coates, 2018[10]), these participants play a significant role in increasing the access to capital markets, enabling more retail investors to participate at affordable costs. This may lead to a larger portion of public savings being used as a source of financing for productive business activities.

The growth of institutional investors also presents challenges (Bebchuk and Hirst, 2019[11]). Their business model depends on economies of scale, which requires a large volume of assets under management. The portfolios of these vehicles are structured based on the representation of each asset in the benchmark index used as a performance parameter. To maintain the lower fees charged to investors, these vehicles need a significant amount of assets under management.

Moreover, there are agency problems and a lack of consistency in the provision of incentives for institutional investors to encourage greater engagement on corporate governance issues with the companies they invest in (Bebchuk, Cohen and Hirst, 2017[12]). While some jurisdictions have legal or regulatory rules that establish engagement incentives, these largely occur through voluntary stewardship codes that operate under the "comply or explain" mechanism (OECD, 2023[6]). Other jurisdictions have

more prescriptive and mandatory regulations that require institutional investors to exercise certain ownership rights over shares. In Chile, for example, pension funds are obliged to attend shareholder meetings and exercise their voting rights if they own more than 1% of a corporation's equity. In Switzerland and Israel, certain types of institutional investors must vote on behalf of their ultimate beneficiaries in decisions of investee companies related to specific matters, such as the election and compensation of directors (OECD, 2023[6]).

2.3 Sustainability as a 'topic du jour': companies' and investors' perspective

The new Chapter VI of the G20/OECD Principles on sustainability and resilience presents recommendations that reflect the growing challenges corporations face in managing sustainability-related risks and opportunities (OECD, 2023[1]). All jurisdictions surveyed for the 2023 OECD Factbook have established relevant provisions regarding sustainability-related disclosure that apply to at least large listed companies (OECD, 2023[6]).

Institutional investors can participate in their investee companies' activities – e.g., by exercising their voting rights, interacting with the board of directors, issuing public statements on specific topics. Institutional investors have also been careful in considering sustainability-related issues, demonstrating their attention to the risks and opportunities that climate change and other environmental and social factors may pose to the companies in their portfolio (OECD, 2022[13]).

Notwithstanding, regarding sustainability matters, institutional investors may lack the necessary safeguards and incentives to fully exercise their ownership rights in accordance with best corporate governance practices. The involvement of these investors in sustainability-related issues has been the subject of intense debate. One of the main issues is connected to the purpose of the corporation. Some believe that corporations should only be focused on satisfying the interests of shareholders and maximising dividends (the so-called "shareholder primacy") (Hansmann and Kraakman, 2000[14]). Thus, it would not be the role of companies to safeguard the wider stakeholder objectives, but rather to focus on the interests of shareholders, improving results to be distributed as profits to them. This would be the sole objective of companies, and issues related to other fields would be out of the scope of corporate law and capital markets, to be addressed by other branches and areas.

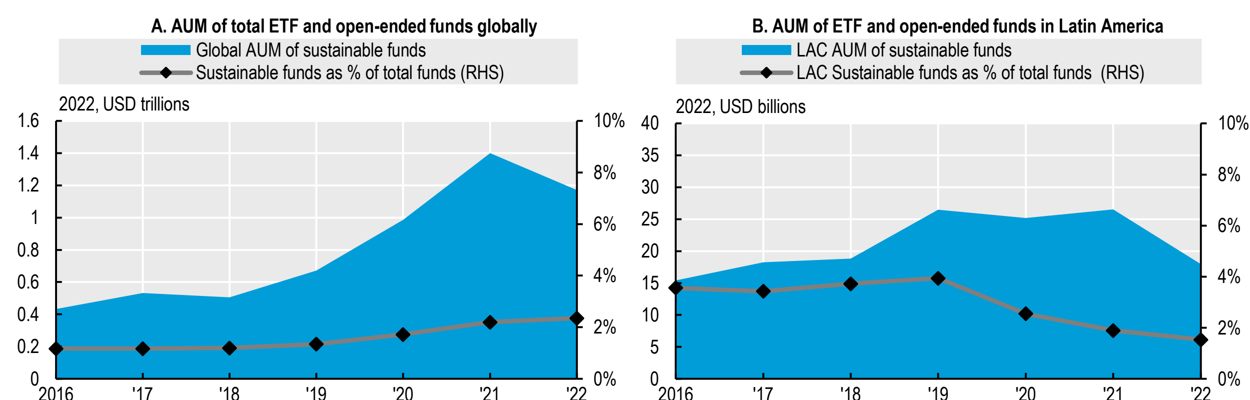
Nevertheless, as mentioned in a recent OECD report, "at least since the Principles [of corporate governance] were first adopted in 1999, consideration of stakeholders' interests has been featured as a relevant consideration, notably in relation to the recommendations contained in […] the Principles on the role of stakeholders in corporate governance. Moreover, the shift of general discourse in favour of broader consideration of non-financial goals has been accelerating in recent years. […] Clearly, a company's commitment to all its stakeholders is not irreconcilable with its long-term profitability. After all, loyal customers, productive employees and supportive communities are essential for a company's long-term capacity to create wealth for its shareholders. In any case, it should be noted that corporate law does not typically adhere fully to the 'shareholder primacy' view, allowing companies to alternatively serve some stakeholders' interests potentially at the expense of short or long-term profitability." (OECD, 2022[13]).

Over 700 institutions, with total assets under management (AUM) of USD 68 trillion, have voluntarily joined Climate Action 100+. The initiative aims to ensure that the largest greenhouse gas emitters (GHG), which currently represent more than 80% of global industrial emissions, reduce their emissions to meet the targets defined by the Paris Agreement (Climate Action 100+, 2023[15]). This initiative has gained support from participants in various developing countries.

Since 2016, investment funds that identify themselves as sustainable or climate funds – by using terms such as "ESG", "sustainable", "Paris alignment", "climate transition" or similar expressions in their labelling – have been receiving increasing net inflows. In 2016, the AUM of these funds totalled USD 432 billion against USD 1 171 billion in 2022 (Figure 3, Panel A). In 2021, all sustainable funds experienced a

significant rise, but in 2022 they represented only 2.35% of the entire funds' market. Meanwhile, climate funds had an average AUM of USD 130 million over the 2016-22 period. Specifically for climate funds, their AUM were almost 3 times larger in 2022, reaching USD 195 billion, compared to 2016 when they totalled USD 69 billion. In Latin America, although the AUM of sustainable funds increased from 2016 to 2021, it decreased in 2022. As a result, the share of sustainable funds compared to the total fund market decreased below 2% (Figure 3, Panel B).

Figure 3. Assets under management for sustainable funds vs traditional funds



Note: Funds retrieved from Morningstar Direct classified as ETF and open-ended funds. Sustainable and climate funds have been selected based on the labelling, that included some key words like "Climate", "ESG", "Sustainable", "Paris alignment" and "Climate transition", including the translations in other languages. Climate funds include all the funds that specifically refer to "climate change", "Paris alignment" and "climate transition". Funds without any asset value are excluded.
Source: Morningstar Direct, OECD calculations.

Recently, legislators, regulators, and other policy makers globally have focussed on strengthening standards, taxonomies, the comparability, and the credibility of reported data related to sustainability matters (Climate Bonds Initiative, 2022[16]). Brazil has recently announced a sustainable taxonomy action plan, consolidating current proposals to develop a standardisation framework for sustainable finance in the region. The goal is to be aligned with international commitments towards sustainable finance (Reis, Cardomingo and Mello, 2023[17]). Mexico (Secretaría de Hacienda y Crédito Público, 2023[18]), Chile (Ministerio de Hacienda, 2023[19]), Colombia (Gobierno de Colombia, 2022[20]), and other jurisdictions in Latin America (United Nations Environment Programme, 2023[21]) have undertaken similar steps.

An additional concern with respect to the increasing involvement of institutional investors in sustainability matters relies on legal concerns about the relationship between final investors (as beneficial owners) and asset managers. Asset managers have a fiduciary duty to their investors. If the managed assets are used for purposes other than those previously announced, this scenario may potentially be considered as a violation of fiduciary duties (Texas Attorney General, 2022[22]); (BlackRock, 2022[23]).

Some of the largest asset managers globally have proposed an alternative to transfer the right to exercise ownership rights over investments in a portfolio to the final investor. This measure grants the actual owners of assets under management the ability to determine the practices of the investment chain. It also serves as a defensive mechanism by offering clients – especially those who are potentially dissatisfied with the prevailing market guidance towards sustainable practices – the ability to express themselves as they see fit. This tool has been criticised due to a number of reasons. Firstly, it may contradict one of the key pillars and reasons for the very existence of asset managers, which is based on qualifications, specialisation, and technical expertise in managing third-party assets, including the responsibility to make decisions regarding the exercise of rights associated with investments. Secondly, it creates potential issues related to fiduciary duties as the voting instructions determined by their clients can conflict with the best interests of the

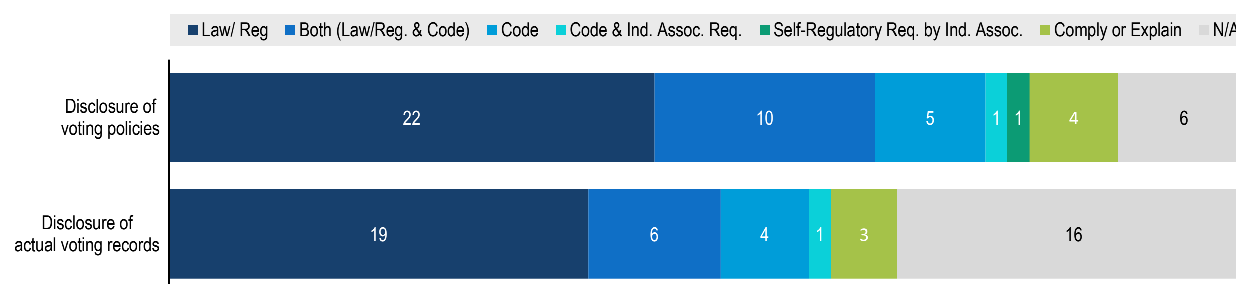
collective pool of assets gathered under the same investment vehicle or even violate the mandate expressly conferred to the asset manager. Lastly, if beneficial owners of investment funds do not exercise the voting rights, it may increase absenteeism and the power vacuum in monitoring and supervising companies (Fisch and Schwartz, 2023[24]).

2.4 Stewardship codes

The last trend and key issue to be addressed involves the use of stewardship code as a complementary mechanism for good corporate governance practices. Subprinciple III.A of the G20/OECD Principles states that stewardship codes “may offer a complementary mechanism to encourage [institutional investors’] engagement (OECD, 2023[1]).

Stewardship codes aim to help institutional investors in enhancing their engagement with investee companies. An increasing number of jurisdictions have recently adopted stewardship codes or required disclosure by institutional investors on how they engage with investee companies and vote in shareholder meetings. Out of the 49 surveyed jurisdictions, only six do not require or recommend that some institutional investors disclose their voting policies (OECD, 2021[9]). Two-thirds of the surveyed jurisdictions recommend or require the disclosure of the actual voting records (Figure 4).

Figure 4. Disclosure of voting policies and voting records of institutional investors



Note: Based on 49 jurisdictions. N/A = no requirement or no available data. The category “Code & Ind. Assoc. Req.” refers to jurisdictions that possess both a code and a self-regulatory requirement by industry association(s) without comply or explain disclosure requirements.
Source: (OECD, 2023[6]).

Three main reasons have led to institutional investor stewardship becoming increasingly important: (i) the growth of the use of passive investing strategies; (ii) the sharp rise in the value of executives' remuneration; and (iii) the fact that some companies may have been slow in addressing the growing concerns of many asset owners of sustainability issues.

Passive investment strategies have gained popularity in recent years, with equity ETF and open-ended funds following such strategies holding USD 11.4 trillion in assets globally. This amount represents 13.85% of the market capitalisation of large and medium-sized listed companies, which amounts to USD 85.6 trillion (as per the MSCI ACWI). In the United States, for example, domestic passive funds constitute 17.6% of the market capitalisation of companies included in the S&P500 (Bloomberg, Morningstar, OECD calculations). These numbers do not include mutual funds and other investment vehicles that may follow an index closely without explicitly identifying themselves as passive investors. Although passive investment funds offer investors low-cost and highly diversified options for investment, their increasing importance has raised some concerns. For example, if there are not enough active investors assessing companies’ values, market prices may fail to reflect all publicly available information; and misalignment between the interests of executives and shareholders may arise if the latter does not monitor executives’ performance and engage with them.

Although the issue of whether executives in corporations are being overpaid or not is a complex one, the reality is that their pay has increased significantly over the last 20 years. According to one estimate (Hargreaves, 2018[25]), in 2016 the ratio between the average CEO pay in a listed company and the pay of an employee was 129 to 1, which is a rise from 48 to 1 in 1998 in the United Kingdom (during the same period, the cumulative growth rate in productivity was 21%, according to OECD.Stat). In the United States, the same ratio increased from 42 in 1980 to 347 in 2016 (the cumulative growth rate in productivity in the country was 60% during the same period). Some may perceive that executives have been generously rewarded for a result that has been limited to the economy. One possible response to this perception would be to require institutional investors to monitor more closely and vote on the compensation policies of listed companies' executives.

Some corporate governance frameworks and companies may have been slow to respond to a rapidly expanding concern by many asset owners with sustainability matters. Notably, engagement has been central to investors preoccupied with climate change who understand that selling securities issued by high-carbon emitting companies is ineffective as long as many other investors are willing to hold these securities. For instance, Norges Bank Investment Management's "2025 Climate Action Plan" states that "voting can be a powerful tool in cases where companies fail to manage material climate risks and opportunities adequately" (Norges Bank Investment Management, 2022[26]).

More stewardship-related regulation or asset owners' demand for institutional investor engagement may come at a cost of poorly informed engagement and voting in shareholder meetings, as well as an incentive for more visible proxy fights, whereas silent constructive engagement may be more effective. This may be the case if institutional investors either do not allocate sufficient resources to engage and to decide how they will vote or outsource their decision to a proxy advisor without diligently supervising the quality of the advice received. Policy makers may reduce the risk of poorly informed voting avoiding the establishment of unrestricted requirements to engage or to vote and, therefore, focusing any stewardship-related regulation on reducing the asymmetry of information between institutional investors and their clients to an optimal level. Policy makers may also require proxy advisors to disclose how they develop their voting recommendations and minimise their conflicts of interest (e.g., due to consulting services provided to listed companies), as well as requiring institutional investors to supervise the quality of the proxy advice received.

In any circumstance, the challenge of policy makers is especially difficult in the current context where foreign investors own more than 40% of the capital in listed companies in several jurisdictions, including Brazil, the Netherlands, and the United Kingdom (De La Cruz, Medina and Tang, 2019[8]). The situation where the beneficial owner, the institutional investor and the investee company are in three different jurisdictions with distinct expectations for stewardship may not be uncommon. Moreover, some initiatives have been recently created by institutional investors based in different jurisdictions to coordinate their engagement actions concerning specific sustainability matters, such as the aforesaid Climate Action 100+.

Promoting constructive engagement and high-quality voting is a defiant task for policy makers, including financial regulators. Institutional investors have different business models and strategies. Passive investors usually have well-diversified portfolios and charge low fixed fees from their beneficial owners. Given the size of their holdings, they can help reduce public bads created by some of their biggest investees, such as reducing the leverage of large financial institutions or the carbon emissions of oil majors (Condon, 2020[27]). In contrast, some institutions invest in a small number of companies and closely monitor them, like some hedge funds. However, their equity participation may not give them enough power to replace executives or change their decisions.

In all cases, regulators and courts may be able to sanction violations of fiduciary duties by institutional investors, but this would typically be possible only in extreme cases of gross negligence and bad faith. For example, not voting would hardly be sanctionable in the absence of a specific obligation to do so. Notwithstanding, policymakers' intervention can still be effective in at least two ways. First, to require institutional investors to be clear to their clients whether they will engage with investee companies and

vote their shares and, if this is the case, disclose their engagement objectives and how they plan to implement that goal. Second, to facilitate the coordination of investors that effectively want to engage with companies while preventing anticompetitive behaviour and abusive actions.

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4. Notes

[1] As reported by major institutional investors in their respective stewardship reports, here are a few examples: (i) BlackRock's 2023 Global Voting Spotlight notes that from July 1, 2022 to June 30, 2023 the institution "held 4 000 engagements with more than 2 600 unique companies in 49 markets, effectively covering more than 75% of the value of our clients' equity assets managed by BlackRock (BlackRock, 2023[32]). In the annual period of (2018-2019), the reported number of engagements was nearly half of this number (BlackRock, 2019[28]); (ii) Vanguard reported a total of 1 049 engagements for the period from June 1, 2022, to July 31, 2023, reaching invested companies that represent approximately 75% of the institution's assets under management in the United States (Vanguard, 2023, p. 1[29]). In Latin America, this percentage stood at 39% (Vanguard, 2023, p. 9[30]), (iii) State Street recorded, in 2022, the completion of 956 engagements, reaching invested companies that represent approximately 49% of its portfolio in assets under management (State Street, 2023, p. 30[31]).