

OECD Corporate Governance Working Papers No. 11

Institutional Investors as Owners: Who Are They and What Do They Do?

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https://dx.doi.org/10.1787/5k3v1dvmfk42-en

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Institutional Investors as Owners
Who are they and what do they do?

By Serdar Çelik and Mats Isaksson*

This paper provides a framework for analysing the character and degree of ownership engagement by institutional investors. It argues that the general term "institutional investor" in itself doesn't say very much about the quality or degree of ownership engagement. It is therefore an evasive "shorthand" for policy discussions about ownership engagement. The reason is that there are large differences in ownership engagement between different categories of institutional investors. There are also differences in ownership engagement within the same category of institutional investors such as hedge funds, investment funds, etc. These differences arise from the fact that the degree of ownership engagement is determined by a number of different features and choices that together make up the institutional investor's "business model". When ownership engagement is not a central part of the business model, public policies and voluntary standards aiming to improve the quality of ownership engagement among institutional investors are likely to have limited effect. Based on an empirical overview of the relative size of different categories of institutional investors, the paper identifies a set of 7 features and 19 choices that in different combinations define the institutional investor's business model. These features and choices are then used to establish a taxonomy for identifying different degrees of ownership engagement ranging from "no engagement" to "inside engagement".

JEL Classification: G30, G32, G34, G38
Keywords: corporate governance, institutional investors, incentives, shareholder engagement, shareholder activism.

* This paper was produced by Serdar Çelik and Mats Isaksson, Corporate Affairs Division, OECD Directorate for Financial and Enterprise Affairs. The authors would like to thank their colleagues in the OECD, delegates to the OECD Corporate Governance Committee and the participants in the project on Corporate Governance, Value Creation and Growth for their valuable comments. They would also like to thank the Capital Markets Board of Turkey whose financial support has contributed to making this work possible.

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PART I. SUMMARY, CONCLUSIONS AND POLICY IMPLICATIONS

During the last decade, most OECD countries have experienced a dramatic increase in institutional ownership of publicly listed companies. In the UK, for example, only 10% of all public equity is today held by physical persons. Moreover, a number of new institutions have entered the scene and have become important owners alongside the more traditional institutional investors, such as pension funds and investment funds.

These developments have given new impetus to the discussion about the role of institutional investors as owners of publicly listed companies. Of particular interest is how they carry out the corporate governance functions that are associated with share ownership. The increase in institutional ownership has also provoked regulatory and voluntary initiatives aiming at increasing their level of ownership engagement. The 1994 interpretation of the US Employee Retirement Income Security Act is one example. A more recent one is the UK Stewardship Code.

While such initiatives have typically increased voting among institutional investors, there is also concern that they have had little effect on the quality of ownership engagement. To minimize the costs that are associated with a voting requirement, many large institutions primarily rely on consultants that, for a fee, provide arguably standardized advice on how to vote and help with the actual process of exercising voting rights.

In this paper we argue that such voting based on a pre-defined formula (passive outsourcing of voting) as well as the total abstention from voting, may be perfectly rational from the perspective of institutional investors. The reason is that the degree of ownership engagement is not determined by share ownership as such. Instead, it is determined by a number of different factors that together make up the institutional investors' "business model". In some business models, active ownership engagement is a vital component. In other business models, ownership engagement has no function whatsoever and a requirement to vote represents nothing but a cost. In the first case mandatory rules on ownership engagement are unnecessary and in the latter case they are likely to have little effect beyond simple box ticking. As a matter of fact, the most active and engaged owners are typically under no regulatory obligations at all to vote or otherwise engage with the companies that they own.

Considering the importance of institutional investors, this paper takes a closer look at the different factors that determine ownership engagement, such as the purpose of the institution, its liability structure and its portfolio strategy. We find that these determinants vary not only between different categories of institutional investors, but also within a given category of institutional investors, for example, hedge funds. Depending on the "business model" ownership engagement among institutional investors will vary from totally passive, to very hands on engagement. As a consequence, we conclude that the general term "institutional investor" in itself doesn't say very much about the quality or degree of ownership engagement. It is therefore an ambiguous "shorthand" in any policy discussions about ownership engagement.

It is important to note that this paper is written from a public policy perspective. So, we need to be clear why the quality of ownership engagement is of wider societal interest. Why should policy makers care? The degree of ownership engagement is hardly a moral issue or a general fiduciary duty that must override other objectives, such as maximizing returns to the institutions' ultimate beneficiaries. Instead, what matters for society as a whole is the role that ownership engagement is expected to play for effective capital allocation and monitoring of corporate performance.

The market economy relies on shareholders to price and allocate capital among different business opportunities. Since the shareholders are assumed to have a self-interest in the return on the capital that they provide, we trust that the shareholders also seek as much information as possible to identify those companies with the best future prospects. Since it is in their own interest, we also expect shareholders to continuously monitor corporate performance to see how well corporations actually use the capital they have been given.

If shareholders fulfil these functions, they carry out a socially beneficial role, since they bring new and unique information to the economy. This new information will improve the allocation of productive resources and make better use of those resources that are already employed. It is therefore the very basis for genuine value creation and economic growth.

Since shareholders are expected to serve these functions, they have also been given the legal rights to carry them out. These rights include the transferability of shares, access to information, participation in key decisions concerning fundamental corporate changes and the election of the board of directors. Exercising these rights is always associated with certain costs, which some shareholders are motivated to pay and some are not.

Shareholders that for some reason do not find it worthwhile to inform themselves or to exercise any monitoring of corporate performance are obviously ill equipped to serve the wider economic role of improving allocation and corporate performance. Instead, their role in the economy will be limited to providing capital. This distinction is not theoretical, since in reality we have shareholders that exhibit different degrees of ownership engagement. This has given rise to a debate about the possibility to differentiate dividends and/or shareholder rights between on the one hand those shareholders that contribute capital, information and monitoring and, on the other hand, those shareholders that only contribute capital.

This paper represents a partly new approach to understanding the ownership engagement by institutional investors. We are aware that both the suggested determinants for ownership engagement and the definition of engagement levels that we present can – and should – be debated and refined. Some of them may be taken out and others should perhaps be added.

Through that very discussion, we hope to contribute to a better understanding of how public policy may strengthen the economic contribution from ownership engagement and perhaps avoid policies that have no effect and even unintended consequences. While it is written from a policy perspective, we hope that the discussion in this paper can stimulate thinking also in the private sector and in individual institutions, where the ability to identify and actually influence the determinants for ownership engagement often resides.

PART II. THE INSTITUTIONAL INVESTOR LANDSCAPE

There is no simple definition of an "institutional investor". The closest we get to a common characteristic is that institutional investors are not physical persons. Instead they are organised as legal entities. The exact legal form, however, varies widely among institutional investors and covers everything from straightforward profit maximizing joint stock companies (for example, closed-end investment companies) to limited liability partnerships (like private equity firms) and incorporation by special statute (for example, in the case of some sovereign wealth funds). Institutional investors may act independently or be part of a larger company group or conglomerate. This is, for example, the case for mutual funds who are often subsidiaries of banks and insurance companies.

Very often, institutional investors are synonymous with "intermediary investors". That is to say, an institution that manages and invests other people's money. But again, there are exceptions. Sovereign wealth funds, for example, can be seen as ultimate owners when they serve as financial stabilization funds or *de facto* state ownership agencies. We also have hybrid forms, such as private equity funds, where the managing partner co-invests, to varying degrees, with the limited partners.

While the picture will become even more complex in parts III and IV of this paper, just the simple fact that institutions are legal rather than physical persons is an important observation with implications for corporate governance. Primarily because it creates at least one additional step in the link between the income of the ultimate provider of money (typically a household) and the performance of the corporation. The fact that institutional investors come in a great variety of forms also suggests that they will differ in terms of the character and degree of ownership engagement. As the importance of institutional investors as owners of public equity has increased, so has the need to understand who they are and what role they play as shareholders. In this part we will therefore provide an overview of who the large institutions are, their relative importance in terms of assets under management and what they own.

As late as in the mid-1960s, physical persons held 84% of all publicly listed stocks in the United States. Today they hold around 40%.[1] In Japan the portion of direct shareholdings is even smaller and in 2011 only 18% of all public equity was held by physical persons.[2] In the UK the decrease in direct ownership is even more pronounced. In the last 50 years, the portion of public equity held by physical persons has decreased from 54% to only 11%.[3]

[1] Data for 1963 and 2011. The US Federal Reserve (http://www.federalreserve.gov).

[2] Data for 2011. The Bank of Japan (http://www.boj.or.jp).

[3] Data for 1963 and 2012. The UK Office for National Statistics (http://www.ons.gov.uk.). The share of foreign portfolio investors has also increased dramatically in the United Kingdom from 7% to 53% between 1963 and 2012. However, national data do not identify foreign owners with respect to their category (e.g. individuals, pension funds). As a consequence, the increase in foreign ownership makes it increasingly difficult to track the relative importance of different categories of owner at a national level. In addition, it is argued that the foreign ownership data for UK is exaggerated since it includes holdings by asset managers whose parent

We have also seen an increase in the number and diversity of institutional investors, with new categories and sub-categories of institutions being added. In this report we refer to three broad "categories" of institutional investors, which to some extent reflect this development. The first category of institutional investors is reffered to as "traditional" institutional investors and comprises pension funds, investments funds and insurance companies. Second we use the term "alternative" institutional investors for hedge funds, private equity firms, exchange-traded funds and sovereign wealth funds. As a third category we have added asset managers that invest in their clients' name. The main reasons for adding this third category is the rapid growth of outsourcing to asset managers and the fact that the UK Stewardship Code recently included asset managers in their definition of institutional investors.[4]

We are fully aware that this list of institutional investors is incomplete. Other categories, like closed-end investment companies, proprietary trading desks of investment banks, foundations and endowments could obviously be added. Partly because of a lack of reliable data[5] and partly because we want to keep the presentation as simple as possible, we have not sought to include all possible types of institutional investors in this paper. This does not affect the analysis and conclusions.

However, even for the institutions that we do include, aggregate data on total assets under management and the allocation between different asset classes is limited. We must also raise concerns about the accuracy of estimations in the data that are actually available. An important reason behind this concern is an increasingly complex investment chain where institutional investors often invest in instruments offered by other institutional investors. Pensions funds may, for instance, invest in private equity funds and insurance companies may buy into mutual funds. At the aggregate level, the result may be a certain degree of double counting. Considering the growing importance of institutional investors and their role as owners of our corporations, improvements in data gathering and processing should be an important priority.

Being aware of existing shortcomings, Figure 1 illustrates the total assets under management of different types of institutional investors and the portion of these assets that they have allocated to public equities. The figure shows that in 2011, the combined holdings of all institutions represented was USD 84.8 trillion. Out of this, 38% (USD 32 trillion) was held in the form of public equity. The largest institutions by far were investment funds[6], insurance companies and pension funds. Together they managed assets with a total value of USD 73.4 trillion of which USD 28 trillion was held in public equity. Alternative institutional investors as a group, represented by sovereign wealth funds, private equity funds, hedge

company is US based but management is conducted from the UK and the manager may be acting on behalf of UK clients (Kay Review, 2012).

[4] The 2012 revision of the UK Stewardship Code includes a classification of institutional investors as asset owners and as asset managers. According to the Code asset owners are the providers of capital including pension funds, insurance companies, investment trusts and other collective investment vehicles whereas asset managers are institutions responsible for day-to-day management of investments.

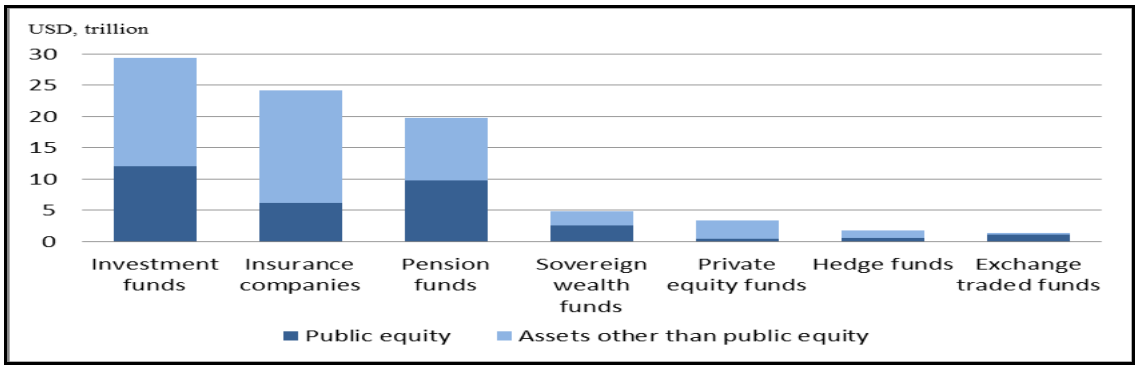
[5] In addition to traditional institutional investors, OECD Institutional Investor Database provides data on other forms of institutional savings under "Other" category, including foundations and endowment funds, non-pension fund money managed by banks, private investment partnership and other forms of institutional investors. Institutions in Other category had USD 1.8 trillion in assets under management as end of 2011.

[6] Investment funds include mutual funds and other investment funds. In some countries, "collective investment schemes" is used to refer investment funds.

funds and exchange traded funds were estimated to hold total assets of USD 11.4 trillion, of which 40% (USD 4.6 trillion) was invested in public equity.

Sections 2.1 - 2.3 below provide a more detailed account of the portfolios of "traditional institutions", "alternative institutions" and "asset managers" respectively. We end this Part in section 2.4 with a discussion about the increased complexity of the investment chain, which in addition to cross-investments complicates the description of the institutional investor landscape.

Figure 1. Total assets under management and allocation to public equity by different types of institutional investors (in trillion USD, 2011)



Note: Investment funds, insurance companies and pension funds data do not cover non-OECD economies. Since institutional investors also invest in other institutional investors, for instance pension funds' investments in mutual funds and private equity, the comparability of different data cannot be verified.

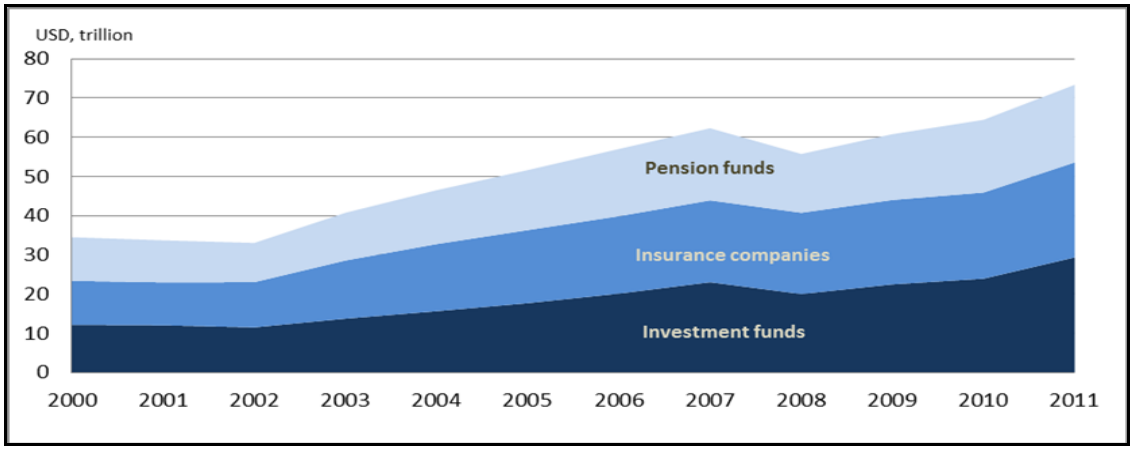
Source: OECD Institutional Investors Database, SWF Institute, IMF, Preqin, BlackRock, McKinsey Global Institute.

2.1. "Traditional" institutional investors

In OECD countries, pension funds, investment funds and insurance companies have in the last decade more than doubled their total assets under management from USD 36 trillion in 2000 to USD 73.4 trillion in 2011. Figure 2 shows that the largest increase among the three categories of traditional institutions has been for investment funds that have increased their assets under management by 121%. As a consequence, their relative share of total assets under management by traditional institutional investors increased from 37% in 2000 to 40% in 2011, while the share held by pension funds decreased from 31% to 27%. The share held by insurance companies remained fairly stable during the period at around 32% of all assets managed by traditional institutional investors.

It is again important to note that both pension funds and insurance companies invest in mutual funds which are part of the investment funds category. In particular, almost 40% of mutual funds' assets in the US are assets of individual retirement accounts (IRAs) and defined contribution pension plans that are invested in mutual funds (ICI, 2012). Considering the fact that institutions based in the US account for almost 40% of total assets under management of OECD traditional institutional investors, a significant part of pension funds' assets may also be counted under investment funds.

Figure 2. Assets under management by traditional institutional investors in the OECD



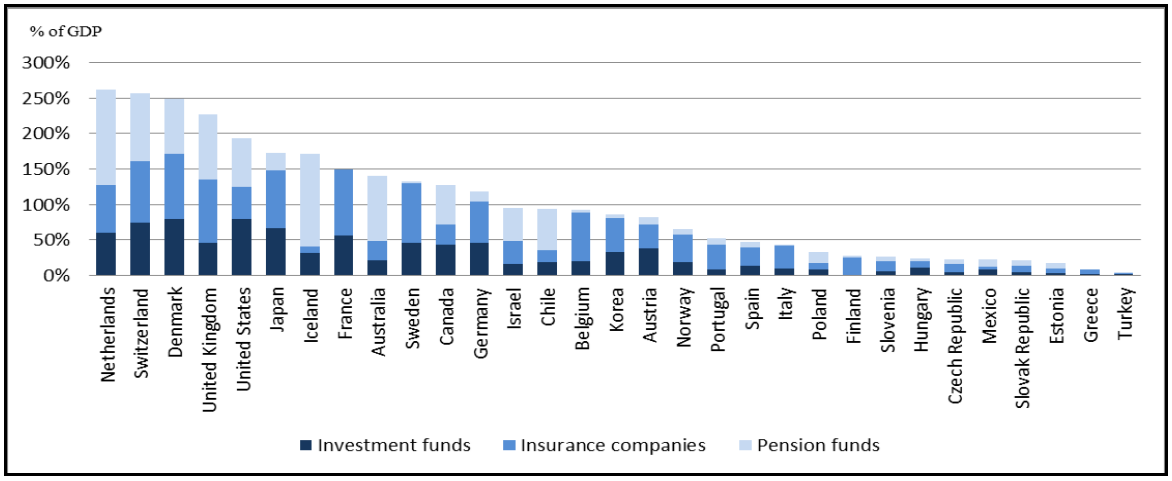
Note: Since insurance companies and pension funds invest in mutual funds, investments funds data also include pension funds' and insurance companies' assets.

Source: OECD Institutional Investors Database.

As shown in Figure 3, the amount of assets managed by institutional investors and the relative importance of different types of institutions vary widely across OECD countries. In the Netherlands, Switzerland, Denmark and the UK, for example, assets under management by traditional institutional investors account for more than twice their GDP. On the other hand, total assets under management by traditional institutions in Hungary, Czech Republic, Mexico, Slovak Republic, Estonia, Greece and Turkey is less than a quarter of their GDP.

In some OECD countries like Australia, Chile, Iceland and the Netherlands pension funds are the dominant form of institutional savings, whereas in Belgium, Finland, Italy, Korea, Norway, Slovenia and Sweden insurance companies are the significant domestic institutional investors. The countries where investment funds is the largest category of institutional investors are Austria, Hungary, Turkey and the US.

Figure 3. Assets under management by traditional institutional investors in OECD countries (% of GDP, 2011)



Note: Since insurance companies and pension funds invest in mutual funds, investments funds data also include pension funds' and insurance companies' assets.

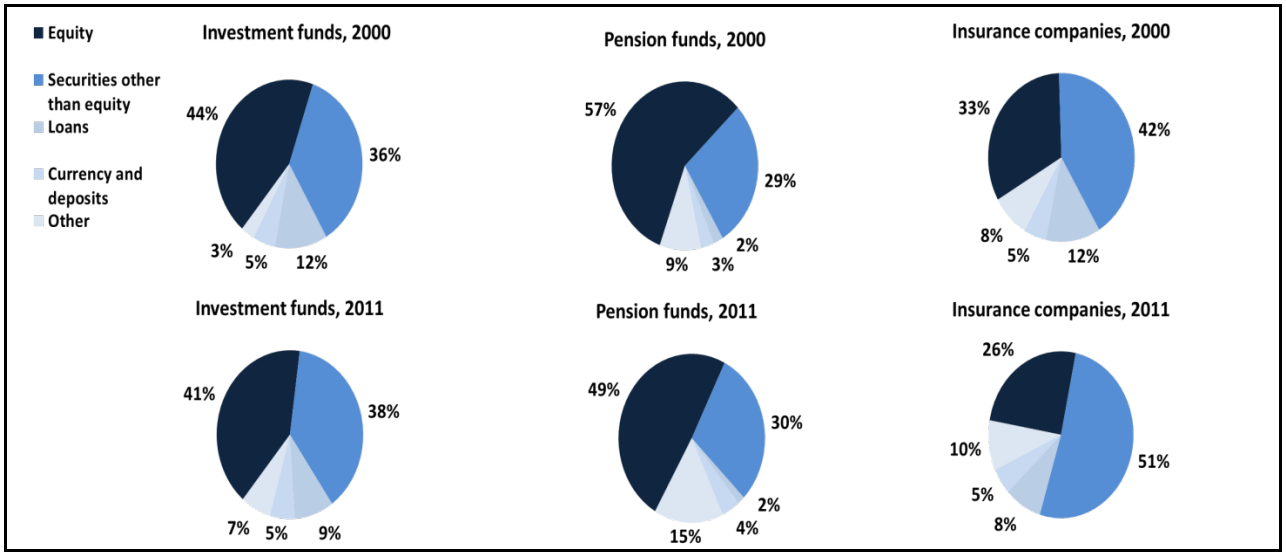
Source: OECD Institutional Investors Database. GDP data from OECD National Accounts.

Figure 4 provides a detailed picture of how the traditional institutional investors allocated their holdings between different asset classes in 2000 and 2011 respectively. For both investment funds and pension funds public equity was the single largest asset class both years. In 2011 public equity represented almost half of the portfolio of pension funds and 41% of the total portfolio of investment funds. Insurance companies held 26% of their assets in the form of public equity.

While public equity was the single largest asset class both years, all three categories of traditional institutional investors decreased their portion of public equity between 2000 and 2011. The largest decrease was for insurance companies which reduced their holdings of public equity by about 22%, while pension funds during the same period reduced their holdings by 14.4% and investment funds by about 7%. For pension funds, public equity was primarily replaced by the category "other", which includes investments in private equity funds, venture capital, hedge funds, real estate, commercial loans and financial derivatives, which increased from 9 to 15% of total assets.

Despite the decrease in their relative allocation to public equity, traditional institutional investors increased their share of all outstanding public equity owned by institutional investors by about 5% between 1995 and 2011. The primary explanation for this is that the 121% increase in their total assets management mentioned above outstripped the growth in global stock market capitalisation. The total stock market capitalisation in the US, for example, was almost at the same level at the end of 2011 as it was at the end of 2000[7]. This is partly explained by the fact that the US stock market lost almost half of its listed companies between 1997 when it had 8 823 listed companies and 2012 when it had only 4 916 listed companies (Weild et al., 2013). The dramatic decrease was partly the effect of de-listings and partly by an 80% decrease in the annual average of new listings, from 525 in the period 1993-2000 to 116 for the period 2001-2012 (Isaksson and Celik, 2013).

Figure 4. Asset allocation by traditional institutional investors in the OECD



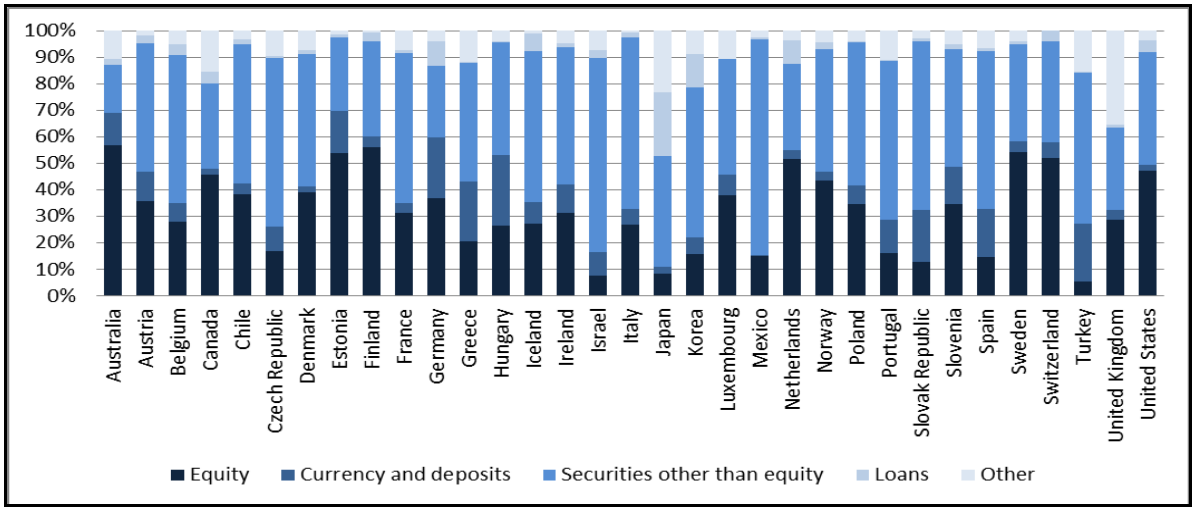
Note: Other category includes investments in private equity, venture capital, hedge funds, real estate, commodities, commercial loans, financial derivatives etc.

Source: OECD, Institutional Investors Database

[7] Market capitalisation data from World Bank World Development Indicators.

Looking at country level data, Figure 5 reveals that in 2011 the asset allocation of institutional investors varied considerably between OECD countries. In many countries, public equity was not the single largest asset class. The allocation to public equity varied from 5.7% in Turkey to 56.9% in Finland. In the US, traditional institutional investors allocated 47% of their portfolio to equities which is almost 51% of the total equity investment by institutional investors from OECD countries. The category "other investments", which includes investments in real estate, private equity, venture capital and hedge funds, constituted an important part of the institutional investors' portfolios in the United Kingdom (35.3%) and Japan (23.2%).

Figure 5. Asset allocation by traditional institutional investors in OECD countries (in percent, 2011)



Note: Other category includes investments in private equity, venture capital, hedge funds, real estate, commodities, commercial loans, financial derivatives etc.

Source: OECD, Institutional Investors Database

2.2. "Alternative" institutional investors

As we mentioned above, there is no clear distinction between what we call "traditional" and "alternative" institutional investors. Nor do we claim that "alternative investors" have a distinct set of common features. The main rationale for the label "alternative" is that they are relatively new and have emerged as an alternative or complement to more "traditional" types of institutional investors. Another reason for treating them separately from traditional institutional investors is that reliable data for hedge funds, private equity firms and sovereign wealth funds is quite limited compared to what is available for traditional institutional investors.

It is estimated that in 2011, the four main categories of alternative investors - hedge funds, private equity funds, sovereign wealth funds and exchange traded funds – together held about USD 11.3 trillion in assets under management globally[8]. This represents around 15% of the amount of assets managed by traditional investors. The portion of total assets that they hold in the form of listed equity varies widely between the four categories of investors. While sovereign wealth funds are estimated to allocate around half of their assets to listed

[8] Of which, sovereign wealth funds, USD 4.8 trillion; private equity firms, USD 3.4 trillion; hedge funds, USD 1.8 trillion and exchange traded funds, USD 1.4. trillion (Sources: SWF Institute, IMF, Preqin, BlackRock).

equity (McKinsey, 2011), private equity and hedge funds as a group have a considerably smaller portion of assets invested in public equity. Almost 80% of ETF assets are allocated to public equities. Taken together alternative institutional investors hold a relatively small portion of the world's public equity equivalent to about USD 4 trillion.

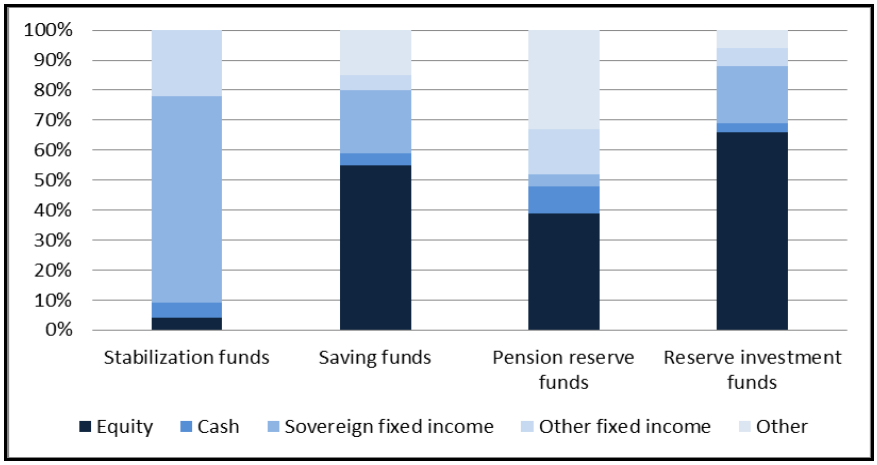
The largest category among alternative institutional investors, measured by total assets under management, is the sovereign wealth funds (SWFs). As mentioned above, SWFs is itself a highly diverse concept in terms of organisational model, governance, purpose and investment strategies. They include stabilization funds, savings funds, pension reserve funds, or reserve investment corporations, with a majority of either savings funds for future generations or fiscal stabilization funds (Kunzel et al., 2011). Some of them serve as central state ownership agencies with controlling stakes in publicly listed state-owned companies complemented with portfolio investments in individual local and foreign listed companies. Some others are themselves state-owned enterprises.

The diverse and evasive nature of SWFs is actually well illustrated by the definition of SWFs used in the *Santiago Principles* (IWG), which were agreed in 2008 and provide a framework for governance, accountability and investment practices of SWFs. The definition includes three main elements, which leave considerable room for variations in terms of organisational forms, governance structure, investment purposes, investment strategies, regulatory constraints, etc.: (i) they are owned by general government, (ii) they manage or administer assets to achieve financial objectives, and (iii) they employ a set of investment strategies that include investing in foreign financial assets.

According to SWF Institute data, Norway, with about USD 560 billion of assets under management is the only OECD country that has a significant sovereign wealth fund. Other countries with large SWF assets are China, United Arab Emirates, Saudi Arabia and Singapore. This points to a regional concentration of SWF assets with 40% of total assets estimated to be in East and South East Asian countries and 35% in the Middle East.

Again, reliable, complete and consistent information about the asset allocation of SWFs is hard to come by and more could certainly be done to improve information about the holdings of central government owned investment vehicles. However, IMF data from 2010 indicate that public equity constitutes a significant portion of their total assets, except for stabilization funds. Figure 6 shows how the asset allocation of different types of SWFs vary depending on their mandates and objectives. For instance, stabilization funds which are established to insulate economies and government budgets from commodity price volatility and external shocks mainly invest in sovereign fixed income instruments (IMF, 2011). The other three sub-categories of SWFs, saving funds, pension reserve funds and reserve investment funds, have relatively longer investment horizons and allocate significant parts of their portfolios to equities. In particular, reserve investment funds that are created to invest foreign reserves to higher return investments allocated 66% of their funds to equities in 2010.

Figure 6. Asset allocation of different types of sovereign wealth funds (in percent, 2010)



Note: Based on publicly available data for 30 SWFs meeting the Santiago Principles definition and explicitly excluding central banks and state-owned enterprises. Based on this analysis the total assets under management by SWFs is estimated to be USD 2.8 trillion.

Source: IMF, Global Financial Stability Report, April 2012

The shortage of comprehensive data is an obstacle also when it comes to identifying and estimating the holdings of what are commonly referred to as private equity firms and hedge funds. Again there is no simple unifying principle in terms of investment strategy or services that defines either category. Traditionally however, private equity firms have been seen as managing a leveraged private pool of capital through active engagement with individual companies, whereas hedge funds use an active investment strategy to benefit from arbitrage opportunities combined with leverage and derivatives (Blundell-Wignall, 2007). It is also common to differentiate between private equity firms and hedge funds with respect to the character, size and the time horizon of their equity holdings in individual companies. Private equity funds are generally seen as having large, long-term holdings in individual non-listed companies. Hedge funds on the other hand are usually associated with small non-controlling stakes in publicly listed companies (Achleitner et al., 2010).

In the years up to the 2007 financial crisis, private equity firms experienced a dramatic surge in assets under management. After the crisis, they continued on a moderate growth path and reached USD 3.4 trillion in 2011 (Preqin, 2012). Out of this USD 3.4 trillion, almost USD 1 trillion is estimated to be in the form of committed capital (Bain & Company, 2012). Only a small part of the remaining USD 2 trillion is invested in listed equities, the rest is invested in different asset classes, including real estate and credit instruments. A simplified way to describe the business model of private equity firms is that they first obtain capital commitments from their investors. These commitments are put in a discrete fund for which the managers of the private equity firm seek investment opportunities. They normally do not receive the committed capital until they find an investment opportunity, but still charge a flat management fee on the committed capital. In addition to the flat fee, the private equity firms also charge a performance related fee that is related to the performance of the investments.

Hedge funds are estimated to hold only about 2% of total assets under management of institutional investors. And compared to the total amount held by institutional investors, their holdings in public equity are quite limited and estimated at about USD 500 million, which is roughly 1% of the total global market capitalisation. Still, hedge funds often play an important role in financial markets and governance by using derivatives and other financial techniques such as share lending, to increase their voting power and their ability to convince other shareholders to influence corporate boards and managers (OECD, 2007). As a

consequence, their relatively modest holdings of equity do not necessarily reflect their role in equity markets and corporate governance (Gilson and Gordon, 2013).

The most recent addition to the family of alternative institutional investors is exchange traded funds (ETFs). ETFs have grown dramatically during the last decade. What in 2000 was a USD 74 billion industry, had in 2011 reached USD 1,35 trillion of assets under management. That is an increase of almost 1,750%. At the end of 2011, there were 3,011 ETFs trading on 40 different stock exchanges around the world.[9] The market for ETFs is relatively concentrated with the top three ETF providers, iShares, State Street Global Advisors and Vanguard, having an almost 70% market share in terms of assets under management (BlackRock, 2012).

Like mutual funds, ETFs are structured like collective investment vehicles that offer diversified exposure to the different financial assets that are included in the fund. Unlike mutual funds, however, ETFs are continuously traded and quoted on a stock exchange (Ramaswamy, 2011). It can be argued that with these characteristics, and the fact that they are sold by large financial institutions, ETFs should be defined as a financial product rather than institutional investors in themselves. They are used by both passive investors to diversify the portfolio and decrease costs, and by active investors such as hedge funds for active investment strategies.

2.3. Asset managers

Finally, and for the reasons explained above, we are also including asset managers under the general heading of institutional investors. In the UK Stewardship Code, asset managers (as opposed to asset owners) are defined as having the day-to-day responsibility of managing investments. The capital that they manage can be provided not only by physical persons, but also by most categories of institutional investors, including pension funds, SWFs and insurance companies. Since institutional investors also trust private equity and hedge funds with the day-to-day responsibility of managing their assets, the distinction between an asset manager and an asset owner is not always clear cut. Asset managers (as we use the term in this paper), however, are not expected to invest in their own name (like a private equity firm would do) but directly in their clients' name and based on their clients' investment policy.

While a few large institutional investors manage their assets internally[10], the last couple of decades have seen an increase in outsourcing of asset management to external asset managers. Globally, asset management firms are estimated to have had about USD 63 trillion under management at the end of 2011 (Towers Watson, 2012). However, some of the asset managers are themselves traditional or alternative institutional investors, that manage their assets through a special asset management arm. This is often the case for insurance companies whose asset management arms are one of the largest categories of asset managers. In addition to managing the assets of the insurance company of which the insurance owned asset manager is an arm, the asset management arm also manages assets on behalf of other institutional investors, including pension funds.

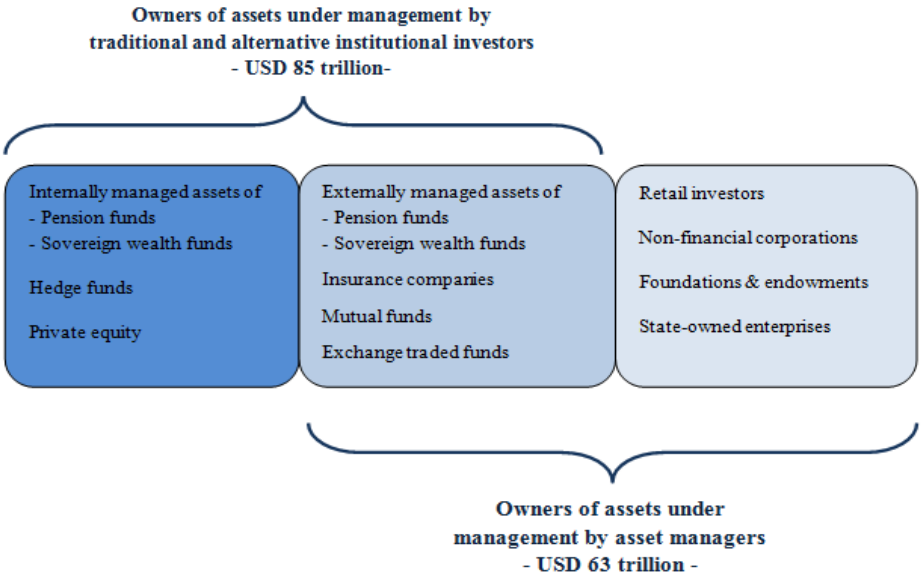
[9] There are also 1 210 other exchange traded products (ETPs) that are similar to ETFs in the way they trade and settle. These products, that do not use a mutual fund structure, had USD 174 billion under management at the end of 2011 (BlackRock, 2012).

[10] A prominent example of internal asset management is the Canada Pension Plan Investment Board (CPPIB), created by an Act of Parliament in 1997, which manages Canada Pension Plan's assets. Others, like California Public Employees' Retirement System (CalPERS), the largest public pension fund in the US in terms of assets under management, adopt a combined approach including both internal asset management and outsourcing.

It is estimated that half of the USD 63 trillion in assets under management by asset managers is split between asset managers that are owned by insurance companies and asset managers that are owned by banks. The remainder is managed by independent asset managers (TheCityUK, 2012).

When we look at the aggregate numbers of assets under management by institutional investors it is important to note that asset managers are by far the largest sponsors of both mutual funds and exchange traded funds, which they offer to their clients as investment products. This means, for example, that the numbers for the "mutual fund" category are almost totally included in the USD 63 trillion registered as assets under management by asset managers. Also exchange traded funds, which is another product commonly sold by asset managers, such as BlackRock, are statistically included in the amount of assets managed by asset managers. Hence, just like there is a case for double counting when a pension fund invests in a hedge fund, the USD 63 trillion in assets under management by asset managers should not be added to the USD 85 trillion in total assets under management by traditional and alternative investors, since there is a considerable degree of overlap. This is illustrated in Figure 7 below.

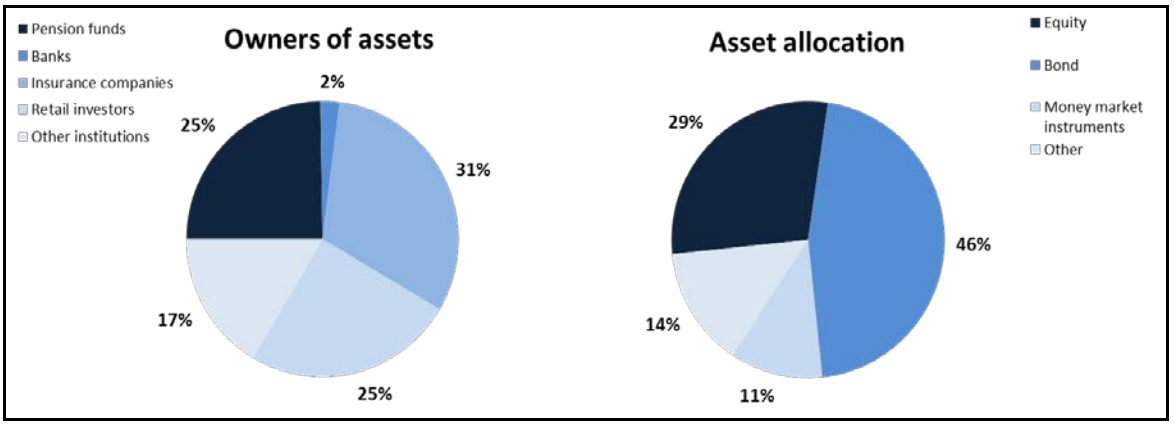
Figure 7. Owners of assets under management by institutional investors



Note: Since institutional investors also invest in other institutional investors, for instance pension funds' investments in mutual funds and private equity, the comparability of different data cannot be verified.

When it comes to the users of asset managers, the right hand side of Figure 8 below shows the owners of assets managed by European asset managers. The figure shows that three quarters of the total assets are provided by institutions and the rest by retail investors. Insurance companies are the single largest owner of assets held by asset managers. However, as discussed above, the assets of insurance companies are mainly managed by their own asset management arms. If we exclude this kind of "internal" outsourcing practised by insurance companies the single largest owner of assets held by asset managers are the pension funds.

Figure 8. Owners and allocation of assets managed by the European asset managers (as percent of assets under management, 2011)



Source: EFAMA (2013), Asset management in Europe: Facts and figures, Sixth annual review.

Compared to Australia, Canada and the the United States, institutional investors in Europe's larger countries typically allocate a smaller portion of their assets to public equity. This is also reflected in the fact that equity allocations of European asset managers are considerably lower than their allocation to bonds. As seen in Figure 8, European asset managers allocate 29% to public equity and 46% to government and corporate bonds.

The asset management industry is fairly concentrated. At the end of 2011, the top 20 asset managers' assets under management accounted for USD 24.4 trillion which was almost 40% of the total assets under management in this industry. As seen from Table 1, 11 out of the top 20 managers are based in the US and account for 64% of the total assets of the top 20. The remaining managers were European (33%) and Japanese (3%). Amongst the top 500 asset managers across the world, there are only 36 firms from emerging markets, namely Brazil, China, India and South Africa (Towers Watson, 2012). Again, it is important to note that, some of the largest asset managers are special asset management arms of traditional or alternative institutional investors, particularly in the form of strategic affiliates of insurance companies.

Table 1. Top 20 largest asset managers in the world (2011)

Rank	Manager	Country	Total assets (billion,USD)		Rank	Manager	Country	Total assets (billion,USD)
1	BlackRock	US	3,513		11	Prudential Financial	US	901
2	Allianz Group	Germany	2,117		12	Amundi Asset M.	France	853
3	State Street Global	US	1,856		13	HSBC Holdings	UK	847
4	Vanguard Group	US	1,849		14	Goldman Sachs	US	828
5	Fidelity Investments	US	1,716		15	Natixis	France	706
6	J.P. Morgan Chase	US	1,342		16	Deutsche Bank	Germany	704
7	Bank of New York Mellon	US	1,260		17	Nippon Life Insurance	Japan	693
8	BNP Paribas	France	1,206		18	Franklin Templeton	US	670
9	Capital Group	US	1,082		19	Northern Trust Global	US	663
10	UBS	Switzerland	946		20	AXA Group	France	661
						Total Top 20		**24,413**
						Total 500		**63,091**

Source: Towers Watson (2012), The World's 500 Largest Asset Managers, based on joint research by Towers Watson and Pensions & Investments

2.4. The complexity of the investment chain

So far in this Part, we have provided an overview of institutional investors including their relative importance in terms of total assets under management and asset allocation. In this section we will briefly illustrate the increased complexity of the investment chain from the original savers (the households) to corporations as an additional factor which complicates the description of the institutional investor landscape. We have divided this complexity into three different parts: (i) increased complexity in cross-investments among institutional investors, (ii) increased complexity in trade practices and (iii) an increase in outsourcing of ownership and asset management functions. We end this section by using one of the largest public pension funds as an illustration.

When we discussed the growth and relative importance of institutional investors above, we pointed to the absence of reliable and comparable data. One of the reasons for the weaknesses in available data is the fact that different categories of institutional investors invest extensively in each other and make use of each other's products and services. Pension funds invest in private equity firms that invest in corporations. Insurance companies invest in mutual funds that outsource to asset managers that invest in exchange traded funds that may very well include shares of the original insurance company and so on and so forth.

According to data from EVCA (2013), pension funds provided 25.2% of the money that went into private equity and venture capital funds in Europe between 2007 and 2012. Insurance companies provided an additional 8.1% and sovereign wealth funds 5.5%. This could not only lead to double counting in the statistics, but also it could also distort the understanding of who is supposed to assume the role of shareholder. In practice it means that the responsibility for ownership engagement may fall between chairs. One concrete example is the effect on ownership engagement from the growing outsourcing of fund management to external asset managers. Asset managers today hold around USD 63 trillion, much of it on behalf of other institutions such as mutual funds and pension funds. Their growing importance is the obvious reason why the UK Stewardship Code recently included asset managers in the definition of institutional investors that should consider the code. However, asset managers are obviously profit maximizing entities with the overall objective of maximizing income and minimizing costs. Particularly costs that are associated with ownership engagement, since they have very few or no incentives in their business model that would motivate them to exercise any form of ownership engagement. Not surprisingly, the asset managers contested this inclusion and the notion that they had the same fiduciary duties that are typically associated with institutional investors (Financial Times, 2012).

Another type of "ownership outsourcing" that has increased significantly in the last decade is the use of so called proxy advisors. The core business of proxy advisors is to sell information and recommendations on which institutional investors base their voting and to sell services that help with the actual process of voting. A major driver behind the use of proxy advisors has been the interpretation of the US ERISA Act of 1974, which has generally been perceived as a requirement for broad categories of institutional investors to vote their shares. Under such requirements, the reliance on proxy advisors is often a rational and cost minimizing tool that allows institutions to live up to the regulatory expectations. The largest proxy advisory firm, Institutional Shareholders Services (ISS), claims to serve more than 1 700 institutional clients, including 24 of the top mutual funds, all of the top 25 asset managers and 17 of the top public pension funds (Daines et al., 2010).

According to ISS they cover more than 40 000 shareholder meetings in over 100 different countries. To carry out this enormous task they have 250 staff dedicated to corporate governance research. This means that each researcher on average has to cover 160 shareholder meetings per year. That is 3 ordinary shareholder meetings every week, all year

round. Again, proxy advisors, like independent asset managers are themselves profit maximizing companies with the overall objective of maximizing income and minimizing costs. This has called into question the quality of the advice and the use of ready-made templates for recommendations that do not take into consideration local and company specific circumstances, but rather apply a one-size-fits all approach[11].

The complexity of the investment and governance chain is also influenced by important changes in the equity market structure, trading practices and investment strategies. An increased use of dark pools and off-exchange platforms has raised concerns about the price discovery process and questioned the equal access to market information. Driven by technological advancements, trade practices have become more sophisticated with quantitative methods and new instruments to which only limited number of market participants have full access.

In short, we are today very far from an economy where there is a direct link between the self-interested shareholders whose income is directly dependent on the performance of the company. Instead, we have a very complex landscape of intermediary institutional investors and service providers that operate in an increasingly complex financial landscape. The effects of this development on ownership engagement, which in turn is supposed to improve allocation of capital and monitoring of corporate performance, are largely unknown to policy makers.

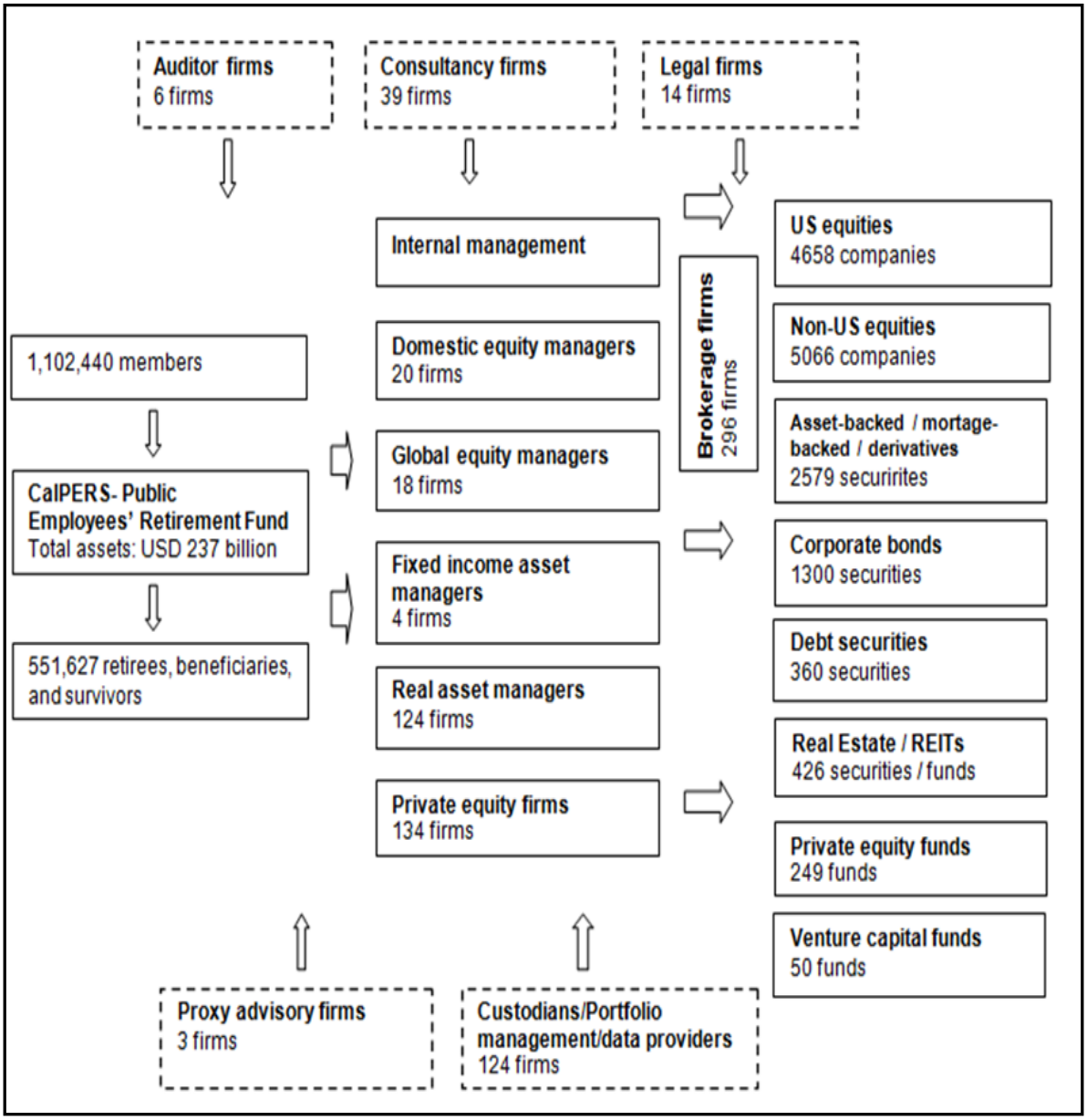
The complexity described above can to some extent be illustrated by the structure of ownership and asset management in the California Public Employees' Retirement System (CalPERS). CalPERS manages the largest US public pension fund. In June 2012 they had USD 237 billion of net assets under management and in Figure 9 we show the plethora of investments, intermediaries and service providers that are involved in taking care of that money.

In June 2012, CalPERS owned shares in almost 10 000 different listed companies using, in addition to internal managers, almost 40 external equity managers and 296 brokerage firms. To support voting the shares they paid 3 different proxy advisory firms. CalPERS also has substantial holdings in other asset classes and outsources some of the management to 4 fixed income asset managers, 124 real estate managers and 134 private equity firms. In total, CalPERS pays USD 974 million for external management. The single largest portion of that goes to private equity firms that CalPERS, in the financial year ending 30 June 2012, paid almost USD 0.5 billion in fees. An additional USD 246 million[12] was paid to other investment related service providers such as proxy advisors, custodians, portfolio managers and data providers. In short, taking care of the funds for current and future retirees is an important industry with many interested parties.

[11] The European Securities and Market Authority's (ESMA, 2013) final report on the role of the proxy advisory industry concludes that there does not appear to exist a clear market failure in this industry. It does nevertheless notes that there are several areas, particular relating to transparency and disclosure, where improvements are needed. ESMA also notes that proxy advisors should be aware of the local market, legal and regulatory conditions. From a corporate governance perspective, however, the quality of proxy advisors' services depends on whether their analytical method also takes into account company specific characteristics.

[12] Of which USD 39.4 million was attributed to staff costs related to internal asset management.

Figure 9. The complexity of the investment chain – CalPERS case (June 2012)



Source: CalPERS Comprehensive Annual Financial Report, Financial Year Ended June 30, 2012 and CalPERs Annual Investment Report, Financial Year Ended June 30, 2012, www.calpers.ca.com

PART III. OWNERSHIP ENGAGEMENT BY INSTITUTIONAL INVESTORS

In Part II we illustrated how institutional investors have become the dominant owners of public equity in most OECD countries. We showed the relative importance of different categories of institutional investors and increased complexity in the investment chain.

We also illustrated that the general concept of "institutional investor" is not very useful when it comes to predicting the character and degree of ownership engagement. Even the more detailed definitions of institutional investors, such as "hedge fund" and "sovereign wealth fund", are quite evasive. This is an important insight for any policy maker that wants to understand, or perhaps even influence, ownership engagement among institutional investors. And it is food for thought for policy initiatives that often address the institutional investment community as a homogenous group (Millstein, 2008).

In this part, we will look beneath the surface of labels and discuss the different factors that influence the degree of ownership engagement by institutional investors. We will conclude that if we want to predict, or perhaps influence, the degree of ownership engagement among institutional investors we must focus on specific features of the institution's business model that determine the incentives for ownership engagement. These features include characteristics such as the purpose of the institution, their liability structure, the regulatory framework, etc. We will illustrate how these features vary, not only between different categories of institutional investors, but also within each category of institutional investors.

For this purpose, we have identified seven main features, or components, of an institution's business model. And for each of these features we have identified a number of choices and regulatory conditions that in turn determine the character and degree of their ownership engagement.

Before we discuss these different determinants of shareholder engagement it is important to remind ourselves why the degree of ownership engagement is a public policy concern. Why should policy makers care? From a public policy perspective, ownership engagement is not a moral issue. Nor can it be seen as a general obligation or fiduciary duty that would override other objectives, such as maximizing the return to the institution's ultimate beneficiary. What is primarily matters for public policy is the role that ownership engagement plays for effective capital allocation and the informed monitoring of corporate performance.

A well-functioning market economy requires the presence of shareholders that have a self-interest to allocate their money to the most prosperous ventures and then monitors these companies to make sure that they make the best possible use of the money. To carry out this job well, it is in the self-interest of shareholders to gather as much information as possible about the corporation's prospects and, whenever necessary, use this information to engage with the company and influence key issues, such as the company's strategic orientation, its dividend policy and board composition. When shareholders gather and use information in this manner they carry out a function that is essential to value creation and and economic growth. In short they are providing society with new knowledge on how it can improve the allocation and use of scarce resources.

Since shareholders are assumed to play this role, they are also given the legal rights to carry it out. These rights include the transferability of shares, access to information, participation in key decisions concerning fundamental corporate changes and election of the board of directors. Exercising these rights is always associated with certain costs, which some shareholders are motivated to shoulder and some are not.

Shareholders that for some reason do not find it worthwhile to gather information about the companies they own and do not contribute to monitoring through any form of ownership engagement are obviously ill equipped to serve the wider economic role of improving allocation and corporate performance. Their role as shareholders is limited to providing risk capital. This distinction is not theoretical, since in reality we have shareholders that exhibit different degrees of ownership engagement. This has given rise to a debate about the possibility to differentiate returns or shareholder rights between those shareholders that contribute risk capital, information and monitoring on the one hand and those who only contribute risk capital on the other hand.

3.1. Determinants of ownership engagement

Equity ownership in its own right is not a determinant of ownership engagement. Moreover, the name of an institutional investor provides limited guidance about the character and degree of their ownership engagement. Instead, we need to look at a range of different factors that constitute the institution's business model and the regulatory constraint under which this business is carried out. These determining factors vary not only between different categories of institutions, but also within a given category of institutional investors, for example, between two different hedge funds or two different pension funds. It is an understanding of these determining factors, rather than the categorization of institutional investors as such, that will help us predict the character and the degree of their ownership engagement.

To illustrate this, we have identified seven different features that influence how an institution will behave as an owner. For each of these features, different options are available depending on the institution's choice of business model and the regulatory framework in which it operates. We refer to these options as the determinants of ownership engagement. While we have identified some of the more important features and determinants of ownership engagement, we do not claim that the list is in any way exhaustive. At this stage, the features and determinants are mainly selected to illustrate the approach and to stimulate further discussion about which features and determinants to include. The features and determinants are briefly discussed in the following sections 3.1.1. – 3.1.7. and summarized in Table 2 below.

3.1.1. The purpose of the institution

An important distinction among institutional investors is between those that have a profit maximizing obligation to the institution's owners and those that do not. A public pension fund, for example, typically does not have any shareholders that expect a return on an investment in the pension fund. Rather, they are often run as public agencies or some other, not incorporated, legal form. The sole focus is on the returns to the beneficiaries. The incentives to work towards this objective can obviously be affected by the fact that a public institution is under limited pressure to attract capital (customers) in competition with other institutions. This distinction between institutional investors with captive assets and institutional investors that have to compete for assets in the market may itself be a determinant of ownership engagement. Many other institutional investors however, are organised as joint stock, profit maximizing companies. In some instances these entities, or their parent companies, may themselves be publicly listed companies. This is true for many investment funds that are owned and marketed by banks. To be attractive, these funds must obviously deliver at least satisfactory results to those who invest in the funds. But they are also under pressure to generate profits to their own shareholders. Profits that typically come from management fees paid by those that invest in the fund. For such funds, there is always a trade off in terms of the resources they spend on attracting savers by improving the portfolio value (for example, through ownership engagement) and the resources they spend

on other classical means of attracting customers, such as marketing and product differentiation.

3.1.2. The liability structure

An important part of an institution's business model is the choice of liabilities. Basically what kind of products they are offering the investors. Some institutions, like life-insurance companies, specialize in long-term obligations, while the commitments of other institutions, for example, mutual funds, are undefined or short term. When long-term obligations, for example, the maturity of a pension plan, can be calculated with accuracy, the institution is able to match its portfolio liquidity accordingly. The liability structure of, for example, mutual funds on the other hand, where investors can exit without prior notice, typically requires a fully liquid portfolio. The liquidity requirement may in some instances be an obstacle to ownership engagement, for example, if board participation in a portfolio company triggers legal restrictions on the shareholders ability to trade the shares in the company.

3.1.3. The investment strategy

There is no given number of investment strategies. And in principle we may find as many investment strategies as there are investors. In Table 2 below we have nevertheless identified four main strategies that are associated with different business models and are at the same time relevant for the degree of ownership engagement. The strategy "passive index" is basically a (sometimes binding) commitment to hold a portfolio that mimics a predefined index of shares. Indexes may be constructed in different ways, but the important point here is that the composition is pre-defined. The companies are not typically chosen on the basis of fundamentals and adjustments in the portfolio are not by active choice, but rather the automatic result of changes in the index weighting. Many mutual funds and pension funds use this strategy. Per definition, the holding period for individual stocks is very long, or at least as long as another strategy is applied.

By "passive fundamental" we refer to investors that initially make an active choice in selecting the individual companies in which to invest and then keep them for an extended period of time. Examples could be "strategic" national investments by a sovereign wealth fund or core investments of a closed-end investment company.

The "active fundamental" strategy is supposed to illustrate a business model where an investor relies on continuously buying and selling companies that are chosen on the basis of fundamental analysis, for example, cash richness or fairly short-term growth potential. This strategy is often associated with a high degree of, at least temporary, ownership engagement to bring about certain changes in the company, such as an increase in dividends. The strategy is often associated with so called "activist hedge funds". Finally, rather than being active and fundamental, institutions might apply an active strategy that relies on the quantity rather than the quality of information about individual companies. Such an "active quantitative" strategy is typically based on the large inflow of information processed by sophisticated software and used in the form of high frequency trading that has extremely short time frames for transactions and that benefits from stock exchanges' co-location services. This choice of investment strategy provides minimal incentives for ownership engagement.

3.1.4. The portfolio structure

A main determinant for the degree of ownership engagement arising from portfolio structure is the degree of concentration. Or in other words, how many companies does the institution have to look after. The degree of portfolio concentration obviously covers a large spectrum, from institutions with very few holdings, to institutions like CalPERS that hold stocks in as

much as 10 000 different companies. The implications for ownership engagement are simply arithmetic. The costs of exercising the same quality of informed and engaged ownership in 10 000 companies is obviously much higher than if you monitor only a handful. This is why institutions with highly diversified equity portfolios abstain from ownership engagement. Or minimize the costs of monitoring by buying services from consultancy firms that carry out the function following a pre-defined formula. As one fund manager put it "since we invest by formula we vote by formula"[13]. While a highly diversified portfolio is a pretty good determinant of an institution's ownership engagement, the same is not necessarily true for concentrated portfolios. An institution with a fairly concentrated portfolio may still exhibit limited ownership engagement. Some foundations and certain sovereign wealth funds could be examples.

3.1.5. The fee structure

As mentioned above, many institutional investors are themselves profit maximising institutions that make money from the fees that they charge from their clients. There are two main types of fees: (i) flat fees, which are associated with, for example, mutual funds and (ii) performance fees, which are typically associated with more sophisticated institutions such as hedge funds and private equity firms. Some institutions also charge a combination of the two. The way in which the choice of fee structure determines the degree of ownership engagement is not straightforward. Ultimately, it will depend on how the institution sees the costs and benefits of using a high degree of ownership engagement to improve performance. Neither for mutual funds that charge flat fees, nor for quantitative hedge funds that charge performance fees, is ownership engagement typically an option. From the perspective of ownership engagement it is also of interest to note that there are examples where the institution's business model is to charge very low or no fees at all, but rather rely on income from share lending. Some exchange traded funds are examples of this.

3.1.6. The presence of political and social objectives

For profit making institutions, there is no a priori reason that political and social objectives should enter as a determinant of ownership engagement. The extent to which they do align their ownership engagement with such objectives is likely to depend on their business model, marketing and product differentiation strategy. An example could be mutual funds that want to attract investors who want to avoid holdings in certain companies regardless of the returns. Not-for-profit institutions, such as public pension funds, sovereign wealth funds and endowments may very well have political and social objectives that translate into a certain kind of ownership engagement or positions on specific governance issues.

A special case in point is the various types of public pension funds where the boards are appointed by governments; sometimes following a formula of stakeholder representation. In certain instances the most relevant framework for understanding the incentives for ownership engagement in such institutions may be the public choice theory, which applies economic tools to political science. Boards and managements in such organisations may focus their ownership engagement on other aspects than the efficient allocation and monitoring of corporate performance.

3.1.7. The regulatory framework for ownership engagement

While company law does not require any specific degree of ownership engagement from individual investors, in some jurisdictions there is a complementary regulation that does. Within the OECD, such regulations range all the way from quasi mandatory obligations for

[13] The director of proxy voting services at Wells Fargo (Lowenstein, 1991).

certain institutions to vote their shares, to regulations that explicitly prohibit certain institutions to vote any shares. In the United States, for example, institutions that are subject to the ERISA Act are, according to an interpretive bulletin in 2008, generally assumed to have a *de facto* obligation to vote all shares under management. In the UK the Stewardship Code is an alternative way to encourage shareholder voting. Conversely, in Sweden the Swedish pension fund AP7, which manages pension savings for 3 million people, is explicitly prohibited by law from voting their shares in any Swedish companies. The same is true for mutual funds in Turkey which are prohibited participating in the governance of the investee companies. This has been interpreted by the industry as a voting ban.

Between these extremes, countries can also have limitations on the portion of shares in an individual company that an institution may hold and vote. In some instances, the companies themselves may introduce voting caps that limit the number of votes a shareholder cast in their articles of association. Voting caps are allowed in, for example, Belgium, Denmark, France, Norway, Spain, the UK and the US. It is also fairly common that the disclosure of voting policies and practices be addressed in their rules and codes. This is the case in, for example, Australia, Chile, Denmark, Germany, Israel, Italy, Japan, the Netherlands, Spain, Switzerland, the UK and the US where regulations and/or national codes include requirements to disclose voting policies (OECD, 2013).

While they would not be specific to any particular institution, there are sometimes references to regulatory or administrative obstacles to cross-border voting (European Commission, 2011; OECD 2011). However, considering the high turnout levels in the countries with high foreign ownership, such as the UK with over 40% foreign ownership and an average turnout of almost 70% in shareholder meetings, the obstacles to cross-border voting may not have a significant impact on voting.

The institutional features and determinants for ownership engagement that are discussed above are summarized in Table 2 below.

Table 2. Determinants of ownership engagement

Purpose	Not for profit		For profit	
Liability structure	Long-term		Short-term	
Investment strategy	Passive Index	Passive Fundamental	Active fundamental	Active Quantitative
Portfolio structure	Concentrated		Diversified	
Fee structure	NA*	Performance fee	Flat fee	Zero fee
Political / social objectives	Political/social incentives		No political/social incentives	
Regulatory framework	Engagement requirements	Engagement limitations	No legal requirements/limitations	

*Not applicable for not-for-profit institutional investors.

3.2. Levels of ownership engagement

In section 3.1 we discussed a set of factors and choices that influence an institution's ownership engagement. In the absence of strict regulatory requirements to engage or not engage, the degree of ownership engagement is the result of these factors and choices that

together make up the institutions "business model". The fact that the business model includes the ownership of shares doesn't in itself say anything about the institution's degree of ownership engagement. Both mutual funds and sovereign wealth funds own equity. But their engagement as owner may vary greatly as a result of other factors, such as purpose, investment strategy and portfolio diversification.

As a result of the factors and choices discussed in 3.1, different institutions will end up with different types and levels of ownership engagement. In a survey from 2010 more than half of the asset owners and asset managers reported some form of dialogue with the board or the management of investee companies. However, the character of those contacts varied widely, from campaigns to persuade a company to change their behaviour, to a routine conversation via an email exchange or a telephone call. It is worth noting that 76% of the asset owners and 56% of the asset managers stated that they had five or less staff members devoted to ownership engagement with investee companies (IRRC and ISS, 2011). This number should be compared to the hundreds or perhaps thousands of companies that these institutions may hold in their portfolios and are expected to monitor. Against this background, it is not surprising that limited staff was identified to be the main impediment to ownership engagement.

To illustrate different degrees of ownership engagement we have identified four different levels (or degrees) of ownership engagement ranging from zero engagement to inside engagement. These are indeed fairly broad categories and a large number of variations exist in reality. What is important here however is to illustrate the link between the degree of ownership engagement and the different determinants that were discussed in section 3.1 and summarized in Table 2 above. The conclusion is that any degree of ownership engagement can be perfectly rational and a logical consequence of the choice of determinants that make up the institutions "business model". Below, we briefly discuss the four broad categories of ownership engagement. It is important to remember that, in principle, an endless number of variations between the two extremes could exist.

1. *No engagement:* This category comprises institutions that do not monitor individual investee companies actively, do not vote their shares and do not engage in any dialogue with the management of investee companies. Examples include those exchange-traded funds that do not charge any fees to their investors, but instead generate income from share lending (Wong, 2010). Another example would be institutional investors that are subject to engagement limitations or an outright prohibition to vote their shares, like Turkish mutual funds.

2. *Reactive engagement:* Reactive engagement represents voting practices that are primarily based on a set of generic, pre-defined criteria that guide voting with respect to the different proposals put before the shareholders' meeting. Reactive engagement often relies on buying advice and voting services from external providers such as proxy advisors. It may also consist of reactions to engagement by other shareholders. For example, when an otherwise passive shareholder supports initiatives by another institution such as an activist hedge fund who is attempting to influence the dividend policy in a specific company or to make changes to the board. It may also include reacting to public tender offers from a private equity firm. Reactive behaviour is represented by many US pension funds and mutual funds that – subject to legal requirements[14] - vote their shares with the help of proxy advisors and also respond to shareholder campaigns led by hedge funds or private equity funds (Gilson and Gordon, 2013).

[14] The ERISA Act of 1974 and interpretive guidance 1994 and 2008.

3. *Alpha engagement:* This engagement level is associated with ownership engagement that seeks to support short or long-term returns above market benchmarks. Using quite different strategies, both activist hedge funds and private equity funds can be examples of alpha engagement. Hedge funds that practise alpha engagement usually influence companies through small holdings, sometimes complemented by derivatives, actively seeking the support of other investors to support their intentions (OECD, 2007). Private equity firms on the other hand acquire large or controlling shares of companies in order to be able to restructure the company, improve its performance and, within a pre-defined period, sell with a profit.

4. *Inside engagement:* Inside engagement is an engagement level characterized by fundamental corporate analysis, direct voting of shares and often assuming board responsibilities. Owners at this engagement level typically hold controlling or large stakes in the company. A good example might include a closed-end investment company such as Berkshire Hathaway Inc. This company is the largest shareholder in Coca Cola Inc. and is represented on the board of Coca Cola Inc. by one of its directors. Inside engagement may also be practiced by some sovereign wealth funds.

PART IV. CORPORATE GOVERNANCE TAXONOMY OF INSTITUTIONAL INVESTORS

So far we have discussed how informed and engaged ownership serves an important economic function in society for the efficient allocation of capital and the monitoring of corporate performance. But we have also concluded that many of today's institutional shareholders on rational grounds may not be willing to bear the costs for carrying out this job. The degree of ownership engagement is not tied to ownership of shares itself or to the category of institutional investor as such. Instead, the ability and willingness to serve as informed and engaged owners is determined by a set of different features and choices that together make up the institutions' business model. In the previous section we examined seven features and the choices that can be made. We are well aware that the list is not exhaustive. Other determinants could be added and some of the existing ones dropped. At this stage however the main objective is to illustrate a systematic approach to help us understand the factors that cause large differences in ownership engagement between the large group of shareholders, commonly referred to as "institutional investors" in the policy debate.

In this part we illustrate how the features, choices and levels of engagement that we discussed in Part III can be used as a taxonomy for describing an institution investor's business model and its impact on the character and degree of ownership engagement.

In Table 3 below we have characterised two institutional investors from the general category "hedge funds" with respect to each of the seven different determinants and choices. Both are "active" hedge funds. One is a hedge fund with an active fundamental investment strategy, the other is a hedge fund with an active quantitative strategy.

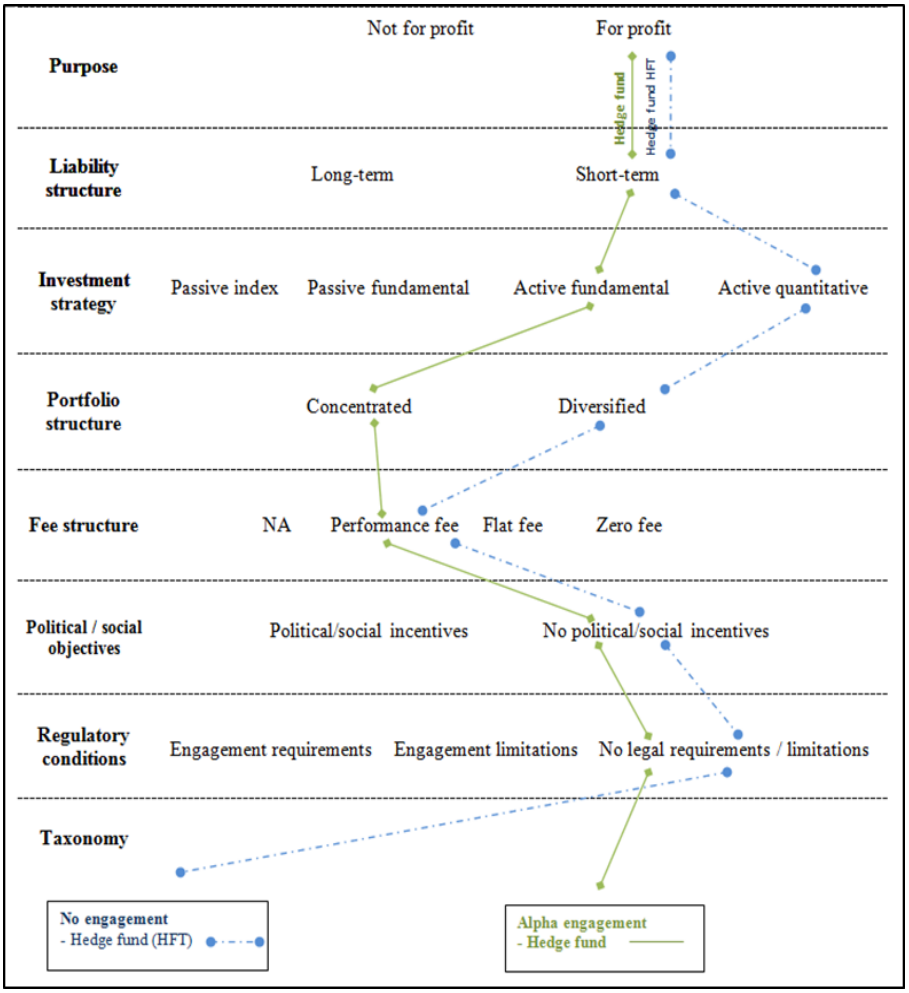
In the first two lines of the table we can see that they are both profit maximizing entities with short-term liabilities. In terms of their investment strategy they differ in that one of them has an active fundamental strategy and the other one has an active quantitative strategy. This means that the maturity of the liability structure in itself does not preclude an active or fundamental investment strategy.

In terms of fees they both charge performance fees, but in terms of portfolio strategy they again differ, since the institution with an active fundamental investment strategy has a concentrated portfolio whereas the institution that has an active quantitative investment strategy holds a diversified portfolio. From the last two lines we can conclude that neither of them have any specific political objectives or legal requirements in terms of ownership engagement. In sum, the two entities have the same characteristics in five out of the seven features. This includes the same overall objective to maximize profits, the character of their liability structure, the fees that they charge, the influence of political objectives and the regulatory framework under which they operate.

Where they differ is in their "investment strategy" and "portfolio structure" and, as a consequence, their respective levels of ownership engagement differ completely. The hedge fund that follows an active fundamental strategy with a concentrated portfolio will pick its investments carefully and most likely be heavily engaged in the governance of the portfolio corporations, perhaps demanding changes in strategy, dividends and board composition.

The hedge fund choosing a quantitative strategy and diversified portfolio will most likely show no interest in the governance of individual companies in the portfolio and will instead rely on sophisticated software to process large quantities of information that is used for high-frequency trading through a co-located server. We have named these two levels of ownership engagement "alpha engagement" and "no engagement" respectively. Again, the main purpose of this example is not to illustrate the already well-known fact that hedge funds differ in terms of ownership engagement. But to show the usefulness of understanding and identifying the determinants that lead to these differences. And furthermore, if any of these determinants can (or should) be influenced by public policy.

Table 3. No engagement and alpha engagement



In Table 4 below we provide an example that includes two non-profit institutions. One is a sovereign wealth fund with a domestic investment arm and the other is a public pension fund. Both have long-term liabilities and are passive in the sense that they keep the same stocks for a long time. The pension fund, on the one hand, chooses the portfolio composition by using a pre-defined index. The SWF, on the other hand, has a fundamental investment strategy, perhaps guided by national industrial development objectives.

These investment strategies obviously result in different portfolio structures, yet in terms of fees and potential political pressures these two institutions operate under fairly similar conditions. In terms of the regulatory framework however, the public pension fund is required to vote the shares, whereas the SWF is not subject to any such requirements. Regardless of this, the SWF will, due to the character of its investment strategy, be very hands-on in terms

of ownership engagement. The public pension fund will primarily be reactive in the sense that it will either follow initiatives by other shareholders or the advice of proxy advisors that follow some pre-established criteria for voting. We have called these two levels of ownership engagement "inside engagement" and "reactive engagement" respectively.

The fact that a voting requirement in itself does not lead to a higher level of ownership engagement is rational in light of the pension funds other choice in terms of business model. Particularly the choice of indexing as a means to pick its portfolio. If the policy rationale for introducing a voting requirement is that the institution in the very first place is totally passive, it is highly unlikely that the voting requirement in itself will change the level of ownership engagement unless other features of the business model are changed at the same time. With strong economic incentives working against engagement, a mandatory voting requirement can only lead the horse to the water, but it can't make it drink.

Table 4. Reactive engagement and inside engagement

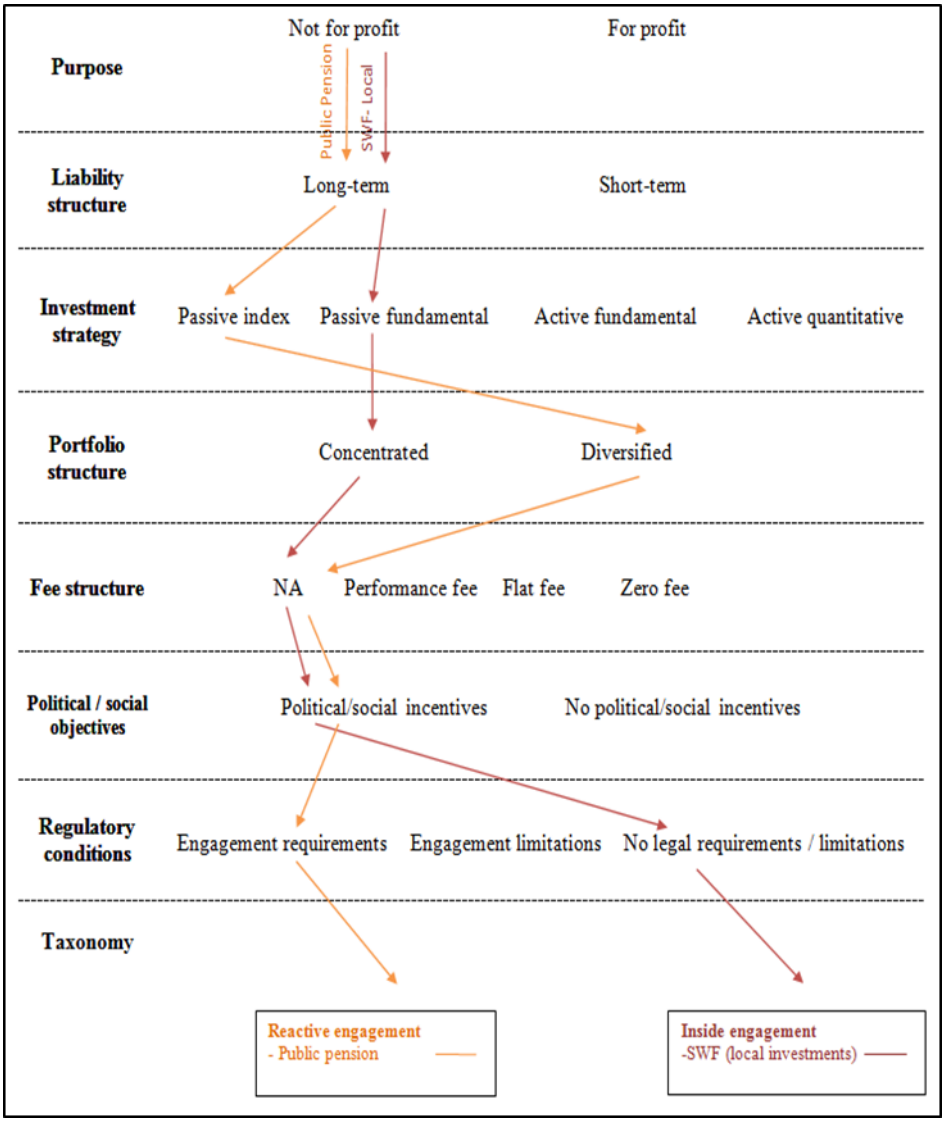


Table 5 below covers all four levels of shareholder engagement and additional examples of institutional investors.

In addition to a hedge fund that practises high frequency trading, examples of "no engagement" include an exchange traded fund that lends the shares in their portfolio and a mutual fund *that is subject to regulatory voting restrictions*. They are all for-profit institutions, with short-term liabilities, diversified portfolio structures and without any specific political or social objectives. An important difference among them is the fee structure. The hedge fund typically has a performance fee structure, the mutual fund a flat fee structure based on assets under management of the fund and the exchange traded fund doesn't charge any fees to its investors, but generates income from share lending. While the hedge fund pursues an active quantitative investment strategy based on sophisticated software and co-location services offered by stock exchanges, both the mutual fund and the ETF pursue a passive indexed strategy. For mutual funds subject to legal limitation on engagement, this is a decisive regulatory condition for their ownership engagement.

For the reactive engagement level, the two examples in Table 5 are a public pension fund and a sovereign wealth fund with a local investment arm. Both are not–for-profit institutions with a long-term liability structure. However, while the sovereign wealth fund has an active fundamental investment strategy for its diversified portfolio, the pension fund pursues a passive index strategy with the same portfolio structure. This means that the SWF buys and sells shares based on company specific information. The pension fund, however, composes its portfolio based on a pre-defined index. The pension fund is typically expected to hold a larger number of companies than the SWF. In both cases, there is some political influence as governments directly appoint or can influence the appointment of managers of the institutions. Additionally, the pension fund has a requirement to vote their shares. With both differences and similarities in their business models, they can both be classified as "reactive engagement".

Alpha engagement is illustrated by a private equity firm and a hedge fund. The private equity firm is a closed end investment pool with a long term (or at least defined) liability structure. The hedge fund on the other hand, is structured as an open-ended pool with withdrawal options for investors and a short-term (or undefined) liability structure. The rest of the determinants are the same for the two of them; they both have an active fundamental investment strategy, concentrated portfolios and a performance related fee structure. Neither of them is under any political or social pressure for shareholder engagement, nor do they have any engagement requirements or limitations. Without any legal or regulatory requirements to seek returns above market benchmarks they both – but through different means - exercise a high degree of ownership engagement.

The last level of ownership engagement, inside engagement, is illustrated by a SWF and a closed-end investment company. Both with controlling or significant stakes in listed companies. The SWF, as a government investment arm, is a not-for-profit institution with political incentives. The bank is a for-profit institution without any political or social requirements in terms of ownership engagement. Neither of them have any short-term liquidity constraints and both pursue a passive fundamental investment strategy with a portfolio that consists of a limited number of companies. Their engagement is typically characterized by direct involvement in the decision-making process of a company, often through participation on company boards.

There have been other attempts to classify institutional investors.[15] The taxonomy presented above differs from most of them, since it does not aim at grouping different categories of

[15] For instance, Goyer (2006) identifies four features that point to systemic differences between institutions: (i) the mode of collecting funds and issuing payments, (ii) the time horizon and liquidity constraints, (iii) the managerial incentives and (iv) the process of picking portfolio companies. Another classification provided by Camara (2005) is related to the dominant incentive creating forces. According to this classification, there are market driven investors

institutional investors based on a specific and systematic criteria. Rather, the purpose is to show that in terms of ownership engagement, different institutions from two different categories may have more in common than two institutions from the same category. While the taxonomy is highly simplified, it is obvious that the informed reader, by using examples from real life, can come up with an almost endless number of combinations of features and choices that in different ways influence the character and degree of ownership engagement. And at this stage, there are at least three important messages:

1. In order to understand the level of ownership engagement we need to identify a whole range of different determinants.

2. Legal or regulatory requirements for voting may have little effect on ownership engagement if other and more dominant determinants for ownership engagement remain unchanged.

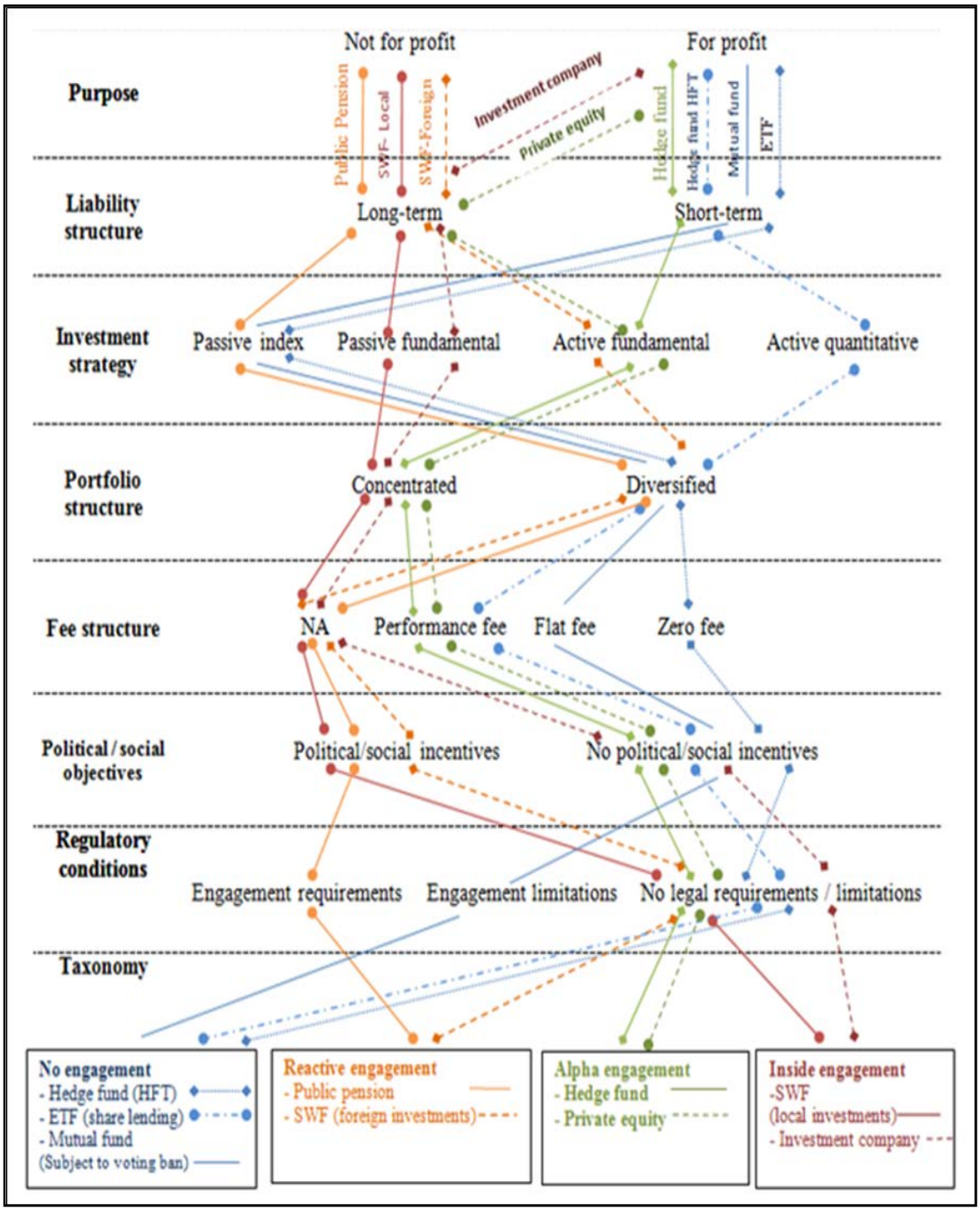
3. Institutions with the highest degree of engagement typically have no regulatory obligation with respect to the degree of their ownership engagement.

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which are principally motivated by financial gains (e.g. hedge funds, mutual funds), politically driven investors that are motivated by a need for the consent of others, like elections (e.g. public pension funds) and socially driven investors that are insulated from market and political forces by some combination of wealth, social position or training.

A recent study from Papaioannou et al. (2013) classifies institutional investors' main characteristics in four groups: (i) short-term liquidity needs, (ii) regulatory constraints, (iii) peer pressure and (iv) financial stability responsibilities. For instance, pension funds have relatively low short-term liquidity needs due to their long-term liability structure under high regulatory constraints. On the other hand, endowment funds with very few liabilities and without regulatory constraints are able to pursue a long-term strategy with a significant allocation to illiquid assets.

Table 5. Corporate governance taxonomy of institutional investors



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