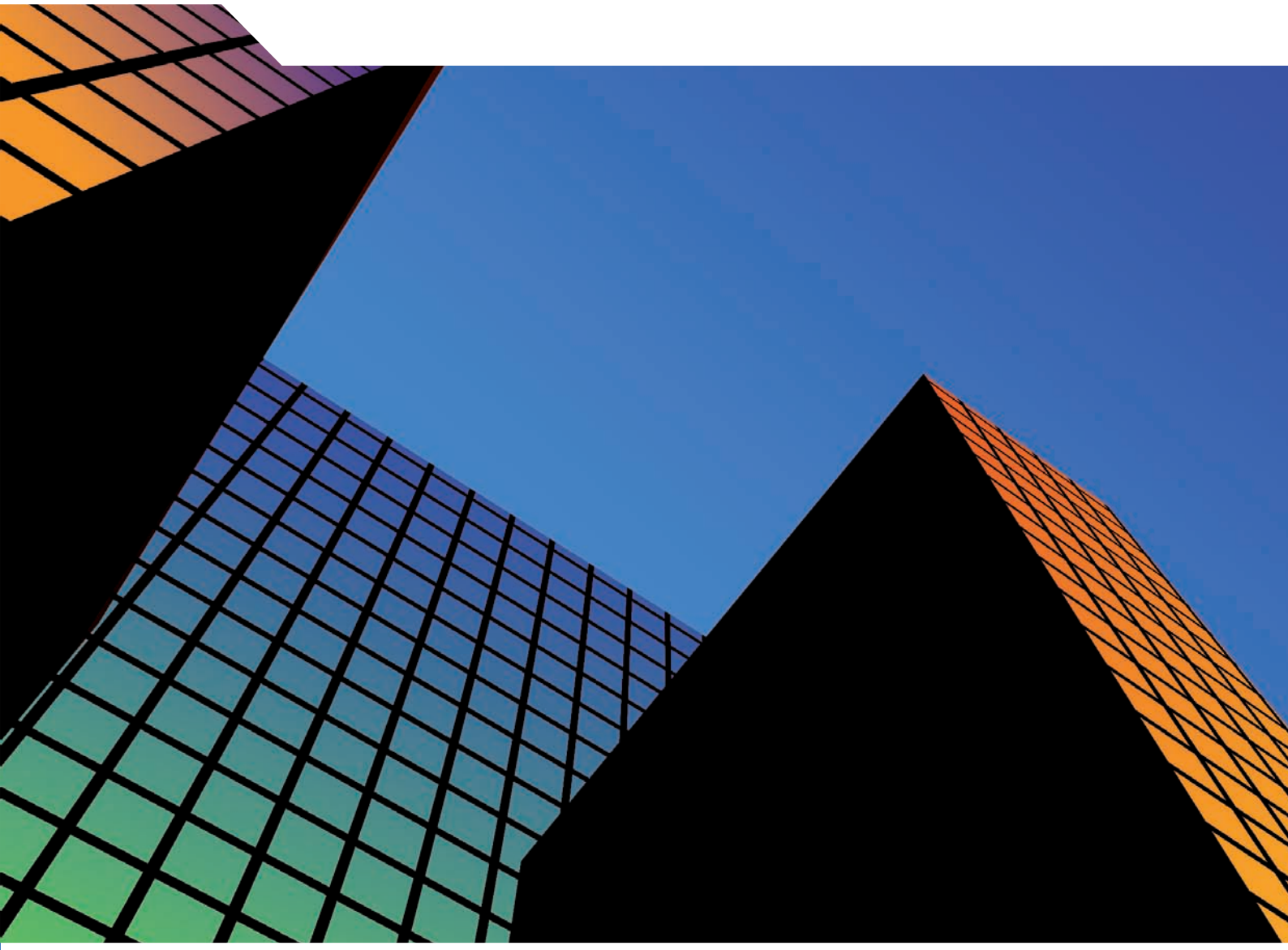
Corporate Governance

The Role of Institutional Investors in Promoting Good Corporate Governance



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Foreword

This report presents the results of the second thematic peer review based on the OECD Principles of Corporate Governance. *The report is focused on the role of institutional investors in promoting good corporate governance practices including the incentives they face to promote such outcomes. It covers 26 different jurisdictions, including in-depth reviews of Australia, Chile and Germany.*

The report is based in part on a questionnaire that was sent to all participating jurisdictions in January 2011 (see Annex A). All countries were invited to respond to the first question so as to provide an overall context within which the review would take place. The three jurisdictions that were subject to the in-depth review were invited to complete all questions.

The report first reviews what is known about the institutional investor landscape including the behavioural codes and legal framework. It then describes what is known about the incentives that condition their actions before considering the record of engagement and voting. The second part comprises the three country reviews. The report was prepared by Grant Kirkpatrick, Héctor Lehuedé and Kenji Hoki with inputs from Simon Wong and Marco Morales and approved for publication under the authority of the OECD Corporate Governance Committee in August 2011.

The OECD corporate governance peer review process is designed to facilitate effective implementation of the Principles and to assist market participants and policy makers to respond to emerging corporate governance risks. The reviews are also forward looking so as to help identify, at an early stage, key market practices and policy developments that may undermine the quality of corporate governance. The review process is open to OECD and non-OECD jurisdictions alike.

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Executive Summary

The *OECD Principles of Corporate Governance* embrace the underlying assumption that shareholders can best look after their own interests, provided they have sufficient rights and access to information. The increased presence of large institutional investors in the last decade fostered the expectation that a new breed of highly skilled and well resourced professional shareholders would make informed use of their rights, promoting good corporate governance in companies in which they invest. Those prospects are reflected in Principles II.F and II.G, added in 2004 to cover disclosure of voting policies, managing conflicts of interest and co-operation between investors. However, institutional investors are not like other shareholders but have a unique set of costs, benefits and objectives. Accordingly, they have not always behaved as desired. This report investigates their behaviour by way of three peer reviews on the implementation of Principles II.F and II.G (Australia, Chile and Germany) and a general review of academic research and country experience.

Institutional investors are financial institutions that accept funds from third parties for investment in their own name but on such parties' behalf. They include pension funds, mutual funds and insurance companies. By 2009, they managed an estimated USD 53 trillion of assets in the OECD area, including USD 22 trillion in equity. Additionally, there are large investments made by the fund management industry directly under their client's name. This makes institutional investors a major force in many capital markets. With the goal of optimising returns for targeted levels of risk, as well as for prudential regulation, institutional investors diversify investments into large portfolios, many of them having investments in thousands of companies. Some managers pursue active investment strategies, but increasingly, they passively manage against a benchmark, resorting to indexing. At the same time, the investment chain has lengthened by outsourcing of management, further distancing investee companies from the beneficial owners. As a result, incentives do not always stimulate institutional investors to engage in monitoring the corporate governance practices of investee companies.

Unlike in the case of private equity and hedge funds, most institutional investors are not remunerated on the basis of the performance of portfolio companies, but on the basis of the volume of assets under management. Moreover, fund performance against a benchmark is reviewed often by investors on the basis of mandates not exceeding three years. Taken together, these factors favour a focus on increasing the size of assets under management and on investing them in indices, rather than on improving the performance of portfolio companies. Incentives for churning of assets and strong conflicts of interest add to those factors and create a challenging context for the notion of institutional shareholder engagement and their promotion of better governance practices. The costs of monitoring a large number of companies are significant, while the benefits are shared with

all shareholders, creating a free rider problem. This often leads to sub-optimal monitoring and analyst coverage of companies unless collective action is achieved.

A key problem identified in the report is that domestic investors in many jurisdictions do not vote their foreign equity. This is important because foreign shareholders make up around 30% of ownership in many jurisdictions. Barriers to cross-border voting that raise the costs of exercising voting rights remain, but evidence shows that there is also a lack of knowledge by institutional investors about foreign companies in their portfolios. This could in principle be solved by making use of proxy advisors, but this raises other concerns. There is the view that the proxy voting industry is already too influential leading to voting and voting recommendations that are "tick the box" in nature and not sufficiently differentiated by country and by company. There is also the question of conflicts of interest prevalent in the industry.

Another relevant aspect of this review deals with whether institutional investors are becoming increasingly short-term investors, or at least promoting short-term thinking by investee companies. Pension funds, especially defined-benefit schemes should be able to make long term investment to match liabilities to their beneficiaries that stretch over many years. But a number of large institutional investors are not acting in this way. Nevertheless, the review also points out that large institutional investors are often locked into the shareholding of most large companies on a long-term basis, since for regulatory or other reasons, diversification and index investing is the norm. Thus they are long-term shareholders even if they buy and sell on a regular basis, or lend their shares for a fee. In principle they have incentives to encourage good corporate governance but such engagement still needs to be encouraged and facilitated.

The nature of institutional investors has evidently evolved over the years into a complex system of financial institutions and fund management companies with their own corporate governance issues and incentive structures. The OECD Principles make useful recommendations in the direction of more transparency and management of conflicts of interest by institutions, and co-operation between investors. However, the old question of shareholder oversight of company boards needs to be re-examined in this new context.

A great deal can be done both by private agents and policy makers to improve the corporate governance outcomes of institutional investors' behaviour. In the private sector, enhancing collaboration among institutional investors, as by establishing industry associations to share the costs of monitoring and voting have shown positive results. On the public policy side, prudential regulations sometimes excessively limit holdings by institutional investors in individual companies and restrictions on incentive schemes may also change their behaviour in an unintended manner. This review shows that given the right set of conditions, institutional investors can play an important role both in jurisdictions characterised by dispersed or concentrated ownership, their role facilitated by private and/or public policy action. Australia is a good example of the former using a private solution: an association of pension funds that conducts background research and advises on proxy voting. In Chile, characterised by concentrated ownership and dominant company groups, policy has increased the powers of institutional investors and created incentives that they often lack in other jurisdictions, with encouraging results.

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Assessment and Recommendations

The proposition that shareholders can best look after their own interests subject to having sufficient rights and access to information is basic to the OECD Principles and domestic law in many jurisdictions. Nevertheless, at the time of the last revision of the *OECD Principles of Corporate Governance* in 2004, the need to deal with the emerging reality of large institutional shareholders was already apparent and led to several new principles being agreed by consensus, especially Principles II.F and II.G covering disclosure of voting policies, managing conflicts of interest and co-operation between investors. The Annotations to the *Principles* went on to note that,

> "the effectiveness and credibility of the entire corporate governance system and company oversight will… to a large extent depend on institutional investors that can make informed use of their shareholder rights and effectively exercise their ownership functions in companies in which they invest."

However, the forces driving the actions of institutional investors are different from many other shareholders being determined by a unique set of costs, benefits, and objectives. This report therefore not only investigates the implementation of the principles covering institutional shareholders by way of three peer reviews (Australia, Chile, Germany) and a general review of academic research and country experience, but also examines the forces, regulatory and economic, driving the actions of institutional investors. Not every constellation of costs and benefits can be expected to lead to good corporate governance outcomes. This approach is based on Principle I.A that was introduced in 2004: "the corporate governance framework should be developed with a view to its impact on overall economic performance, market integrity and the incentives it creates for market participants and the promotion of transparent and efficient markets."

Institutional investors, those financial institutions accepting funds from other parties for investment by the institution in its own name but on their clients/beneficiaries behalf, such as pension funds, mutual funds and insurance, are now a major feature of many jurisdictions and are significant players in the global economy. According to the latest available data, they managed some USD 53 trillion of assets in 2009 in the OECD area, including some USD 22 trillion in equity. In addition, the funds management industry that does not invest in its own name is also highly significant. In a number of jurisdictions, an explicit policy goal is to further the development of institutional investors *via*, for instance, pension funds so as to foster domestic capital markets. However, in other jurisdictions the institutions are seen as a weak link in the company landscape related to short termism and to the pursuit of political ends. Thus some see them as already too powerful and their effects possibly pernicious. Others by contrast, see them as not being robust enough in

promoting good corporate governance and corporate accountability. Not all the arguments in this debate relate to good corporate governance *per se* but to their potential for underpinning growth and development, and addressing other issues such as environmental and social goals. However, there is a close relationship between good corporate governance that promotes company performance and accountability, and addressing these broader issues.

With the goal of optimising returns for targeted levels of risk, institutional investors pursue a range of portfolio diversification strategies, which in some cases have led to highly diversified portfolios, many of them having investments in several thousand companies. Though many managers pursue active investment strategies and use benchmarks for the purpose of assessing performance, some investors seek portfolios that are passively managed against a benchmark, in which case managers typically must purchase all the equities in the share index (*e.g.* S&P 500). The level of diversification can therefore be extreme. With the emergence of a broad universe of professional investment managers and increasing access to information, some studies have shown that active strategies, on average, do not significantly outperform the market on a net-of-fees basis. At the same time, and possibly as a result of these studies, investors have increasingly channelled funds into lower cost, passive diversification funds. This trend towards passive diversification may not be conducive to the promotion of good corporate governance. Diversification is, in a number of cases, also driven by prudential regulation such as capping the percentage of a company's equity that can be held by an institutional investor, and not just by individual investor concerns. The review of Chile noted the benefits of permitting pension funds to take a significant stake in companies (up to 7%). Other jurisdictions might want to examine their restrictions to see if they are economically efficient. At the same time, the investment chain has lengthened by outsourcing of management to include investment managers and sub-advisors, further distancing investee companies from the ultimate "beneficiaries". As a result, at every stage of the process there are possibilities that incentives will not encourage institutional investors to take an interest in the corporate governance practices of investee companies.

Institutional investors acting as agents for ultimate beneficiaries are very often not directly remunerated on the basis of the performance of portfolio companies, whether based on company performance or better corporate governance practices. The exception is certain private equity and hedge funds where performance incentives are powerful, often 20% of fund performance. Rather, they are remunerated often on the basis of management fees based on the volume of assets under management. In some jurisdictions such as in the US, performance-based fees are generally not allowed for mutual funds unless the fee also penalises the manager for poor performance (*i.e.* a fulcrum fee). Moreover, fund performance (either absolute or relative) is reviewed often by investors and mandates usually last only around three years. Taken together, the incentive structure often favours a focus on increasing the size of assets under management, not necessarily bad but also not necessarily an incentive to improve performance of portfolio companies, The incentive structure might also contribute to churning of assets (*i.e.* buying and selling often) where it is possible to increase the commissions from transactions. Indeed, a number of institutional investors often exceed their own announced turnover targets. Average holding periods have declined around the world to under one year on average although a great deal of the decline might be due to the rising importance of high frequency traders, another asset class. In addition, the incentive structures influencing many institutional

investors and fund managers are influenced by conflicts of interest including their own ownership by banks and insurance companies, their relationship to company sponsors of pension plans and the fact that they may control many funds that can trade between themselves. Such incentives might work to the disfavour of investors.

In such a system, the costs involved in monitoring the corporate governance practices over a large number of companies are significant but the benefits will be shared with all (*i.e.* the free rider problem). This implies that monitoring and analyst coverage of companies will be sub-optimal unless arrangements can be put in place to promote collective action. This does not mean that institutional investors can or should avoid monitoring and engagement with their investee companies since there are private returns to them and there can be fiduciary duties such as with private sector pension funds (ERISA) in the US that may be fulfilled through voting. But it does mean that such activities might not be pursued as effectively and as energetically as otherwise would be the case. In short, Principle I.A is not likely to be fully implemented in many jurisdictions and as advocated by the Annotations to the principle, a systematic review by jurisdictions might be beneficial to ensure economic performance.

In view of the institutional investor landscape, Principles II.F.1 and II.F.2 appear to be satisfactory if not very ambitious. However, implementation is not robust in many jurisdictions. In practical terms, the restriction of the Principles to institutions acting in a "fiduciary capacity" needs to be interpreted broadly since formal fiduciary duties are not specified in many jurisdictions that often prefer the weaker obligation of loyalty. Formal duties are often specified for both pension funds and collective investment schemes. Many jurisdictions implement the principles through professional codes. Such codes are not often on a "comply or explain" basis so that it is difficult to judge their implementation and impact on behaviour. However, an increasing number of jurisdictions are moving to require disclosure of actual voting records by institutional investors which represents a check on declarations of voting policy and clarifies whether conflicts of interest are being addressed. Where it has been implemented, important conflicts of interest have been highlighted. Principle II.F.2 is thus important dealing as it does with management of conflicts of interest. This is one area where the operation of voluntary codes may not be effective in the face of strong incentives. In some jurisdictions, legal duties to investors (that might also include fiduciary duties that cover acting in their best interests) are in place that may help address the issue.

The importance of co-operation between institutional investors (Principle II.G) to reduce the costs of monitoring has been clearly documented, including in the reviewed jurisdictions. Most jurisdictions permit co-operation and in line with Principle II.G usually include some exceptions regarding the acquisition of corporate control (acting in concert to avoid takeover regulations) and the need for transparency to control market abuse. These safeguards are legitimate but investors do consistently complain about what they regard as considerable legal uncertainties. It appears that in some jurisdictions more needs to be done by policy makers in terms of defining safe harbours, perhaps along the lines of the UK and Australia.

A great deal can be done both by private agents as well as policy makers in many jurisdictions to improve the corporate governance outcomes of institutional investors. With respect to the private sector, the upturn in public interest dominated by the remuneration debate has made institutional investors more active in voting, although the

jury is still out about what they have achieved in terms of promoting remuneration policy in the longer term interests of the company and its shareholders. In Australia, Germany, the Netherlands, UK and US, the remuneration issue has driven a significant increase in voting by investors and in dialogue with companies. The debate over environmental, social and governance (ESG) reporting might also have a similar effect. However, while these issues have made some investors more active, overall they might still be marginal. More importantly, the private sector has also sought to deal with the free rider problem of corporate engagement by establishing industry associations and other joint activities so as to share the costs of monitoring and voting. This has been quite marked in the pension sector although less so in the fund management industry more generally. In addition, there are moves to make investors more informed about how to set an appropriate investment mandate, such as the standard mandate being discussed by the International Corporate Governance Network (ICGN), an organisation comprising major institutional investors.

Public policy must facilitate such private initiatives but this does not obviate the need for policy changes in some areas where restrictions on behaviour might be limiting. This is the case when, for prudential reasons, regulations excessively limit holdings by institutional investors in individual companies and when restrictions on incentive schemes change the behaviour of institutional investors in an unintended manner.

The review demonstrates that institutional investors can play an important role in jurisdictions characterised by both dispersed and concentrated ownership. This might involve both private and policy action. Australia is a good example of the former using a private solution: an association of pension funds that conducts background research and advises on proxy voting. A similar arrangement also exists in the Netherlands and in Switzerland. However, institutional investors also play an increasingly important role in Chile, characterised by concentrated ownership and therefore of relevance to many jurisdictions in the world. It shows that where ownership concentration is high and company groups dominant, policy might want to consider increased powers for institutional investors. Although pension funds had become active some time ago, the recent law codifies the situation: the six pension funds are able to nominate and elect (with support of other minority investors) independent directors who in turn have enhanced powers and responsibilities on the board. Effective participation by institutions has been made possible by cumulative voting. At the same time, and of perhaps even more importance, is the fact that an individual pension fund can acquire shares in a company up to 7% of voting capital. This certainly gives it an economic interest that institutional investors often lack with more limited shareholdings because of prudential and other rules.

A key problem is that at a time of increasingly diversified portfolios, it appears that domestic investors in many jurisdictions do not vote their foreign equity. This is important because foreign shareholders make up around 30% of domestic ownership in many jurisdictions (with the notable exception of the US because of the size of its market capitalisation relative to others). Barriers to cross border voting that raise the costs of exercising voting rights remain even in Europe where there has been a determined push by the European Commission to improve the situation. However, more profound factors are at work. Market participants report a lack of knowledge by institutional investors about foreign portfolio companies. This is certainly the case with those institutional investors with a very large number of portfolio companies. In some cases, despite the dangers in mandating voting, it might be worth requiring them to vote their significant investments regardless of being foreign or domestic equity. The Spanish investment management code

already goes in this direction. Of course, institutional investors can also make use of proxy advisors but this raises other concerns.

At least amongst many boards there is a view that the proxy voting industry is already too influential leading to voting and voting recommendations that are "tick the box" in nature and not sufficiently differentiated by country and by company. There is also the question of conflicts of interest, covered by Principle V.F, as when a proxy advisor also offers advice to companies about how to obtain a good recommendation. Some form of regulation might be required with respect to conflicts of interest. However, private contractual solutions also have an important role in dealing with the situation. Thus in Australia (but also in the Netherlands and Germany) some institutional shareholders require a proxy agency to mark against their own corporate governance codes rather than against the policy of the ratings company. In addition, there is surely a private contractual or competitive solution to conflicts of interest. What is of utmost importance for policy making is to do nothing that could further raise the cost of monitoring and fund management.

A key policy issue concerning institutional investors concerns whether they are only short-term investors, or at least promoting short-term thinking by boards and managements. The case of pension funds, especially defined benefit schemes is often cited where in principle their liabilities to their beneficiaries stretch over many years. Despite this, they very often issue short-term mandates to their investment managers who in turn have their own short-term incentive systems. There is in any case already a long-term element in the market that needs to be better recognised. Large institutional investors are often locked into the shareholding of most large companies on a long-term basis since for regulatory or other reasons, diversification and index investing is the norm. Thus they are long-term shareholders even if they buy and sell the same shares on a regular basis, and even lend them for a fee. They therefore have an incentive to encourage good corporate governance in their large portfolio companies since it is the only way they have to earn greater returns. A number of institutional investors already recognise this. However, a number of large institutional investors are not acting in this way. Private initiatives to encourage such institutions to become engaged should be supported and policy should facilitate this development perhaps through careful definition of the obligation to monitor large holdings.

In the public and policy debate too much time and effort is being taken up in trying to solve the perceived problem of short termism by appealing to the notion of a long-term shareholder who is often compared favourably with "patient family owners". However, a long-term share *holder* is clearly not necessarily a long-term engaged investor and efforts to give incentives to hold shares may not achieve their objective. The essence of the long-term debate might lie elsewhere. Thus the real problem of short-termism may well lie in the executive suites of companies and financial institutions with an emphasis on short payback periods. Nevertheless, in a world of fast moving technologies and competition, defining short termism is still a challenge.

The Principles that cover institutional investors are focused on "bread and butter" corporate governance issues such as voting at company meetings, the nomination and election of board members and to making their views known on remuneration policy. They support acting in co-operation which might take matters much further by underpinning more engagement, while leaving open the concept of long and short-term. However, the UK and the United Nations Principles of Responsible Investment (UNPRI) go much further by

introducing the notion of stewardship which is akin to shareholder responsibility. This topic might be worthy of more discussion by the OECD.

In sum, the nature of institutional investors has evolved over the years into a complex system of financial institutions and fund management companies with their own corporate governance issues and incentive structures. Investment chains have lengthened, increasing the number of institutions between the final beneficiary and an investment in an enterprise. At each point the incentive system might not lead to good corporate governance outcomes. Investment strategies have also evolved with passive investing through indices and exchange traded funds becoming more important so as to lower costs and increase returns to beneficiaries. Against this background, the old question of investor oversight of company boards needs to be examined. The OECD Principles II.F.1, II.F.2 and II.G make useful recommendations in the direction of more transparency and management of conflicts of interest by institutions, and co-operation between investors. However, the primary implementation method of Principles II.F.1 and II.F.2 appears to be through voluntary codes but these might be inadequate in the case of dealing with widespread conflicts of interest. With respect to the exercise by institutions of their voting rights, turnout at company meetings has increased in recent years and there are dedicated corporate governance investors. However, cross border voting remains costly and uncertain. Whether all these developments are sufficient to improve corporate governance outcomes or whether they are just going in the right direction is an open question, but a great deal depends on expectations. If, as in the Principles, the expectation is the exercise of voting rights then the situation has improved over the past decade. If the expectation is that institutional investors act as stewards of companies, then progress might have been limited.

PART I

Overview

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PART I

Chapter 1

The Structure and Behaviour of Institutional Investors

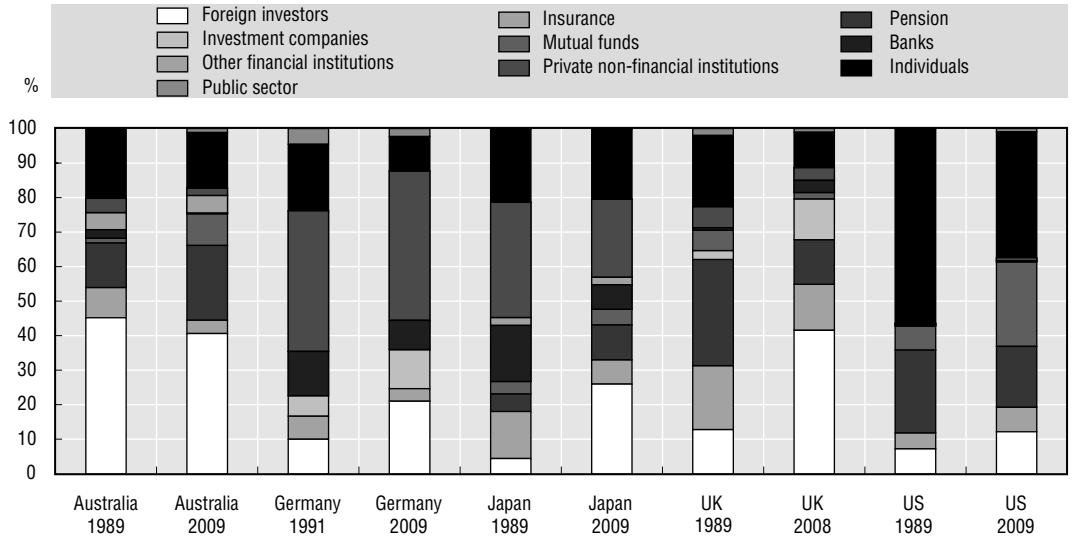
This chapter discusses the market environment, the legal and regulatory frameworks as well as the incentives of institutional investors in exercising their shareholders rights in a manner that is aligned with the broad market expectation that they will promote better corporate governance.

1.1. Background, objectives and issues

1.1.1. The issues

Today, a high proportion of global assets under management are under the operational control of "classic" institutional investors: pension and mutual funds that are often active managers and insurance companies which are normally regarded as more passive.[1] The proportion they hold of equities and company debt is also high in most economies and rising (Figure 1.1). The OECD estimates that in 2009, institutional investors managed financial assets in excess of USD 53 trillion including some USD 22 trillion in equities. As a result, as the Annotations to the *Principles* note, "the effectiveness and credibility of the entire corporate governance system and company oversight will… to a large extent depend on institutional investors that can make informed use of their shareholder rights and effectively exercise their ownership functions in companies in which they invest."

Figure 1.1. **Ownership structure in selected OECD countries**



Source: Australia (2010), *Australian National Accounts: Financial Accounts*, September 2010 available at *www.abs.gov.au/AUSSTATS/abs@.nsf/DetailsPage/5232.0Sep%202010?OpenDocument*; Bank of Japan (2010), *Flow of Funds* (Fiscal Year), available at *www.stat-search.boj.or.jp/ssi/cgi-bin/famecgi2?cgi=$nme_a000_en&lstSelection=11*; Deutsche Bundesbank (2011), Time series database, available at *www.bundesbank.de/statistik/statistik_zeitreihen.en.php*; FED (2011),[2] Federal Reserve Statistical Release, "Flow of Accounts of the United States", several years, available at *www.federalreserve.gov/releases/z1/*; UK (2010), The Office for National Statistics, "Share Ownership Survey 2008", January 2010, available at *www.statistics.gov.uk/pdfdir/share0110.pdf*.

The *Conclusions* (OECD, 2010a) by the OECD also noted that the financial crisis served to underpin long held concerns that the monitoring of boards by institutional investors was generally deficient compared to what was required. Shareholders were described as being either passive or reactionary in the exercise of their voting rights, perhaps

mechanistically relying on proxy advisers, and failing to sufficiently challenge boards. On the other hand, there is also a countervailing view that institutional investors are already much too effective thereby constraining management in favour of short-term policies. Clearly, institutional investors have an important role to play in promoting good corporate governance, even though they represent only one small part of an effective corporate governance system.

While the issues surrounding institutional investors are particularly important for those markets with diffused ownership and a large institutional shareholder base, they are also crucial in most jurisdictions within and outside the OECD area characterised by concentrated ownership. For example, the Latin American Roundtable's *Strengthening Latin American Corporate Governance: The Role of Institutional Investors* (OECD, 2011b) argues that Institutional Investors "can provide an informed counterbalance to controlling shareholders to safeguard against the company's board and management working for interests other than those of the company and its shareholders as a whole". The issue is drawn out in the review of Chile (see Part II). The same can be said in both Asia and in Middle East/North Africa (MENA). Nevertheless, a number of reports note that actual practices have often fallen short of the potential, with institutions too often taking a passive role and failing, or not being able, to exercise their ownership rights in an active and informed manner.

While the public debate often treats the concept of institutional investors as a class, they are heterogeneous in terms of their investment style, strategy, time horizon, concentration, size and investor base. More importantly, recent research reviewed below emphasises their own widely different corporate governance arrangements which leads to differing principal/agent issues and to a distinctive structure of incentives and constraints faced by each. There is also an increasing complexity in the investor chain (for instance, with fund of fund managers adding a layer of asset management) and multiple intermediaries in the ownership chain.[3] Thus there is an increasing separation of ultimate beneficiaries from ownership rights, and from the investee company.

The OECD Corporate Governance Committee decided to undertake a thematic review of institutional investors based on questionnaires to participants of the Committee (see Annexes A and B) and on research by the OECD. Three economies representing different systems would also be examined in-depth ("peer review"): Australia, Chile and Germany. The objectives of the report are therefore:

- to document the scale and complexity of institutional shareholders and the determinants of their behaviour;
- to examine policy issues and the varied responses undertaken by policy makers;
- to test the relevance of the Principles against the emerging landscape and whether they adequately address current and emerging policy challenges, or fall short of expectations; and
- to examine several jurisdictions in detail by way of a "peer review".

For the purpose of this report, the term "institutional investors" refers to institutions which collect funds from investors to invest on their behalf but in the name of the institution. They are thus an "owner" but not a final, beneficial owner. The relationship may or may not have some form of "fiduciary duty" (the term used in the Principles) but certainly they will have some form of responsibility or accountability for use of funds. Thus a bank or insurance company making their own investments are excluded, but their asset

management division using client funds would be included.[4] The classical institutional investors are therefore mutual funds, investment companies, pension funds and asset managers (although they do not invest in their own name) but there are others. Hedge funds and private equity also receive investors' funds to make investments rather than issuing them equity. From the viewpoint of corporate investments only a subset of hedge funds are of interest: those wishing to use votes and/or exert influence to change company policy and corporate governance arrangements (so called activist and event driven hedge funds rather than quants, arbitrage funds and high frequency traders).[5] Hedge funds and private equity have been analysed in OECD (2007) and policy implications in OECD (2008).

1.1.2. The approach of the Principles

The Principles address explicitly the issue of shareholder rights that are important for institutional investors, especially in an international context. For example, Principle II.C.4, *shareholders should be able to vote in person or in absentia, and equal effect should be given to votes whether cast in person of absentia*); Principle III.A.2, *minority shareholders should be protected from abusive actions by, or in the interest of, controlling shareholders acting either directly or indirectly and should have effective means of redress*; Principle II.A.3, *votes should be cast by custodians or nominees in a manner agreed upon with the beneficial owner of the shares*; and Principle III.A 4, *impediments to cross border voting should be eliminated*.

However, three principles go to the heart of the matter. Principle II.F deals with transparency and behaviour: *The exercise of ownership rights by all shareholders, including institutional investors should be facilitated*: II.F.1. *Institutional investors acting in a fiduciary capacity should disclose their overall corporate governance and voting policies with respect to their investments, including the procedures that they have in place for deciding on the use of their voting rights*; and Principle II.F. 2. *Institutional investors acting in a fiduciary capacity should disclose how they manage material conflicts of interest that may affect the exercise of key ownership rights regarding their investments*. Principle II.G deals with the logic of collective action that determines the cost-benefit calculus of monitoring and engagement by voting or otherwise: *Shareholders, including institutional shareholders, should be allowed to consult with each other on issues concerning their basic shareholder rights as defined in the Principles, subject to exceptions to prevent abuse*.

Finally, of great current interest in the post-financial crisis setting is the role of advisors: Principle V.F: *The corporate governance framework should be complemented by an effective approach that addresses and promotes the provision of analysis or advice by analysts, brokers, rating agencies and others that is relevant to decisions by investors free from material conflicts of interest that might compromise the integrity of their analysis or advice*. These principles and the associated annotations reflecting the considerations of the OECD Committee in 2004 are reproduced in Box 1.1.

1.1.3. Outline of Part I

The following section reviews what is known about the institutional investor landscape including investor composition that varies widely across economies. The behaviour of institutional investors is next analysed focusing on the benefits/incentives and costs of voting and monitoring of companies by institutional investors. It assesses what is known about their actual behaviour. It first outlines the regulatory and quasi legal basis (*e.g.* codes of behaviour) for their operations and the type of disclosures they are required to make. It then discusses what is known about their investment strategies and

Box 1.1. **Relevant principles and annotations**

II.F. The exercise of ownership rights by all shareholders, including institutional investors should be facilitated.

As investors may pursue different investment objectives, the Principles do not advocate any particular investment strategy and do not seek to prescribe the optimal degree of investor activism. Nevertheless, in considering the costs and benefits of exercising their voting rights, many investors are likely to conclude that positive financial returns and growth can be obtained by undertaking a reasonable amount of analysis and by using their voting rights.

1. Institutional investors acting in a fiduciary capacity should disclose their overall corporate governance and voting policies with respect to their investments, including the procedures that they have in place for deciding on the use of their voting rights.

It is increasingly common for shares to be held by institutional investors. The effectiveness and credibility of the entire corporate governance system and company oversight will, therefore, to a large extent depend on institutional investors that can make informed use of their shareholder rights and effectively exercise their ownership functions in companies in which they invest. While this principle does not require institutional investors to vote their shares, it calls for disclosure of how they exercise their ownership functions with due consideration to cost effectiveness. For institutions acting in a fiduciary capacity, such as pension funds, mutual investment schemes and some activities of insurance companies, the right to vote can be considered part of the value of the investment being undertaken on behalf of their clients. Failure to exercise the ownership rights could result in a loss to the investor who should therefore be made aware of the policy to be followed by the institutional investors.

In some countries, the demand for disclosure of corporate governance policies to the market is quite detailed and includes requirements for explicit strategies regarding the circumstances in which the institution will intervene in a company; the approach they will use for such intervention and; how they will assess the effectiveness of the strategy. In several countries institutional investors are either required to disclose their actual voting records or it is regarded as good practice and implemented on a "comply or explain" basis. Disclosure is either to their clients (only with respect to the securities of each client) or, in the case of investment advisors to registered investment companies, to the market which is a less costly procedure. A complementary approach to participation in shareholder's meetings is to establish a continuing dialogue with portfolio companies. Such a dialogue between institutional investors and companies should be encouraged, especially by lifting unnecessary regulatory barriers, although it is incumbent on the company to treat all investors equally and not to divulge information to the investors which is not at the same time made available to the market. The additional information provided by a company would normally therefore include general background information about the markets in which the company is operating and further elaboration of information already available to the market.

When fiduciary institutional investors have developed and disclosed a corporate governance policy, effective implementation requires that they also set aside the appropriate human and financial resources to pursue this policy in a way that their beneficiaries and portfolio companies can expect.

Box 1.1. **Relevant principles and annotations** *(cont.)*

2. Institutional investors acting in a fiduciary capacity should disclose how they manage material conflicts of interest that may affect the exercise of key ownership rights regarding their investments.

The incentives for intermediary owners to vote their shares and exercise key ownership functions may under certain circumstances differ from those of direct owners. Such differences may sometimes be commercially sound but may also arise from conflicts of interest which are particularly acute when the fiduciary institution is a subsidiary or an affiliate of another financial institution, and especially an integrated financial group. When such conflicts arise from material business relationships, for example, through an agreement to manage the portfolio company's funds, market integrity would be enhanced if they are identified and disclosed.

At the same time, institutions should disclose what actions they are taking to minimise the potentially negative impact on their ability to exercise key ownership rights. Such actions may include the separation of bonuses for fund management from those related to the acquisition of new business elsewhere in the organisation.

II.G. Shareholders, including institutional shareholders, should be allowed to consult with each other on issues concerning their basic shareholder rights as defined in the Principles above, subject to exceptions to prevent abuse.

It has long been recognised that in companies with dispersed ownership, individual shareholders might have too small a stake in the company to warrant the cost of taking action or for making an investment in monitoring performance. Moreover, if small shareholders did invest resources in such activities, others would also gain without having contributed (*i.e.* they are "free riders"). This effect, which serves to lower incentives for monitoring, is probably less of a problem for institutions, particularly financial institutions acting in a fiduciary capacity, in deciding whether to increase their ownership to a significant stake in individual companies, or to rather simply diversify. However, other costs with regard to holding a significant stake might still be high. In many instances institutional investors are prevented from doing this because it is beyond their capacity or would require investing more of their assets in one company than may be prudent. To overcome this asymmetry which favours diversification, they should be allowed, and even encouraged, to co-operate and co-ordinate their actions in nominating and electing board members, placing proposals on the agenda and holding discussions directly with a company in order to improve its corporate governance. More generally, shareholders should be allowed to communicate with each other without having to comply with the formalities of proxy solicitation.

It must be recognised, however, that co-operation among investors could also be used to manipulate markets and to obtain control over a company without being subject to any takeover regulations. Moreover, co-operation might also be for the purposes of circumventing competition law. For this reason, in some countries, the ability of institutional investors to co-operate on their voting strategy is either limited or prohibited. Shareholder agreements may also be closely monitored. However, if co-operation does not involve issues of corporate control, or conflict with concerns about market efficiency and fairness, the benefits of more effective ownership may still be obtained. Necessary disclosure of co-operation among investors, institutional or otherwise, may have to be accompanied by provisions which prevent trading for a period so as to avoid the possibility of market manipulation.

Box 1.1. **Relevant principles and annotations** *(cont.)*

V.F. The corporate governance framework should be complemented by an effective approach that addresses and promotes the provision of analysis or advice by analysts, brokers, rating agencies and others that is relevant to decisions by investors free from material conflicts of interest that might compromise the integrity of their analysis or advice.

In addition to demanding independent and competent auditors and to facilitate timely dissemination of information, a number of countries have taken steps to ensure the integrity of those professions and activities that serve as conduits of analysis and advice to the market. These intermediaries, if they are operating free from conflicts and with integrity, can play an important role in providing incentives for company boards to follow good corporate governance practices.

Concerns have arisen, however, in response to evidence that conflicts of interest often arise and may affect judgement. This could be the case when the provider of advice is also seeking to provide other services to the company in question or where the provider has a direct material interest in the company or its competitors. The concern identifies a highly relevant dimension of the disclosure and transparency process that targets the professional standards of stock market research analysts, rating agencies, investment banks, etc.

Experience in other areas indicates that the preferred solution is to demand full disclosure of conflicts of interest and how the entity is choosing to manage them. Particularly important will be disclosure about how the entity is structuring the incentives of its employees in order to eliminate the potential conflict of interest. Such disclosure allows investors to judge the risks involved and the likely bias in the advice and information. IOSCO has developed statements of principles relating to analysts and rating agencies (*IOSCO Statement of Principles for Addressing Sell-side Securities Analyst Conflicts of Interest, IOSCO Statement of Principles Regarding the Activities of Credit Rating Agencies*).

Source: OECD Principles of Corporate Governance, 2004.

the economic and other forces that are involved in making these decisions. Investor engagement and the voting behaviour of institutional investors including cross border voting and the costs and barriers that appear to be important around the world are then discussed. Finally, the issue of proxy advisors is considered.

A word of caution is necessary. The institutional investor scene both within and across countries is so complex that the studies available might give a distorted view, in the same way that the blind man describing an elephant based on touching parts of it arrives at widely different conclusions depending on what he has last touched.

1.2. The institutional investor landscape

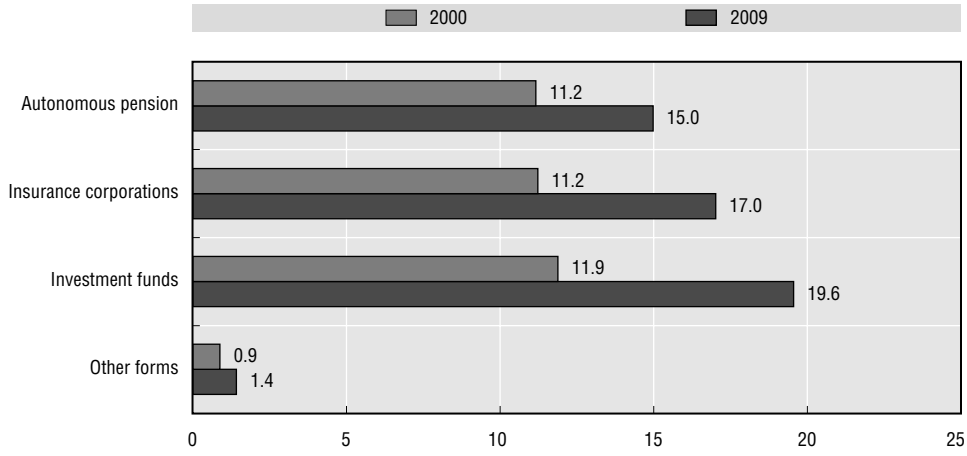
A threshold issue for any review is to obtain a better understanding of the profile of the institutional shareholder base across jurisdictions. Reflecting the complexity of the industry, the existing data on investor types is quite superficial, with little data on, or indications about, characteristics such as concentration, time horizon and strategy which are important inputs if policy makers should wish to promote engagement. Understanding the relative importance of different investor classes in particular markets is easier to

establish but is still limited so that many different data sources need to be utilised, each with problems of differing definitions and coverage,

1.2.1. The investment management industry

Historically major institutional asset managers are autonomous pension funds[6] (either defined benefit or defined contribution schemes), insurance companies and mutual funds (also termed collective investment schemes, CIS) while other forms such as sovereign wealth funds, hedge funds and private equity represent only a smaller share of the industry. The OECD maintains a database using a classification that is based on the financial accounts side of national accounting (Gonnard *et al.*, 2008). By 2009 the investment management industry in the OECD area was responsible for some USD 53 trillion (Figure 1.2) with investment funds the largest single class, although far from dominant. Previous work by the OECD indicated that activist hedge funds accounted for some USD 200 billion in 2006/2007 while private equity funds managed some USD 1.5 trillion worldwide (OECD, 2007).

Figure 1.2. **Financial assets under management by institutional investors in OECD countries**



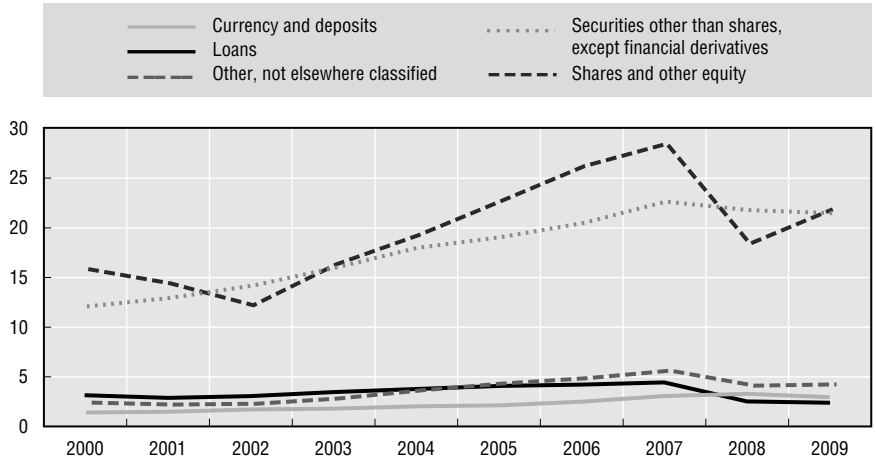
Source: OECD Institutional Investors Database (*http://stats.oecd.org/index.aspx*).

Financial assets under management by institutional investors include not only equities but also bonds, loans, and deposits (Figure 1.3). Institutional investors have invested traditionally in mainly "shares and other equity" (includes quoted shares, unquoted shares, other equity, and mutual fund shares), and "securities other than shares, except financial derivatives" that are simply omitted from securities other than shares and not included in any category as shown in Figure 1.2.

Autonomous pension funds and investment funds held about the same value of shares (Figure 1.4) although pension funds held a higher percentage of their investments in this form, around 57% (Figure 1.5).

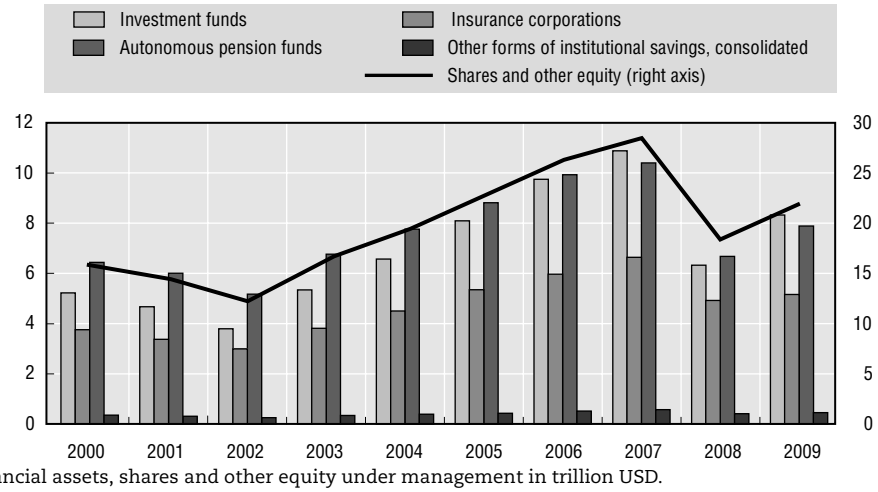
The relative importance of different types of institutional investor varies widely from country to country as shown in Figure 1.6. In some countries like Australia, Chile, Israel and the Netherlands, pension funds are the significant domestic institutional investor but in countries like Germany, France, Norway and Sweden, insurance institutions are key

Figure 1.3. **Type of financial assets managed by the industry (in trillion USD)**



Source: OECD, *Institutional Investors Database* (*http://stats.oecd.org/index.aspx*).

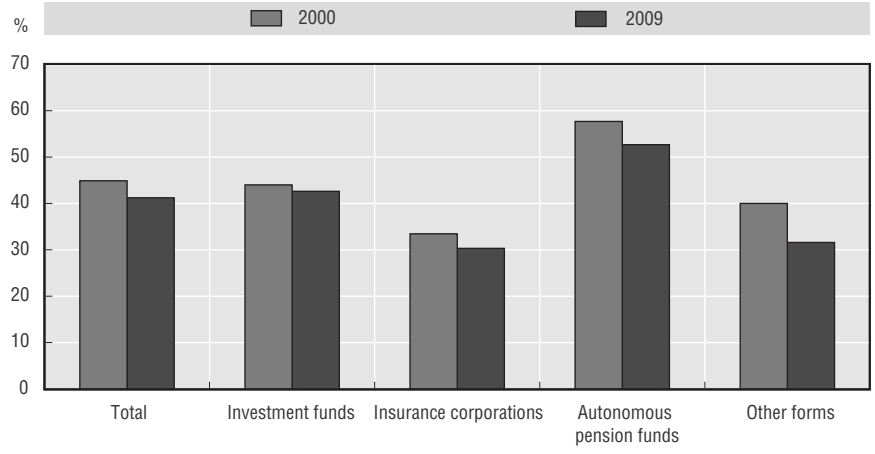
Figure 1.4. **Shares and other equity by class of institutional management**



Note: Financial assets, shares and other equity under management in trillion USD.

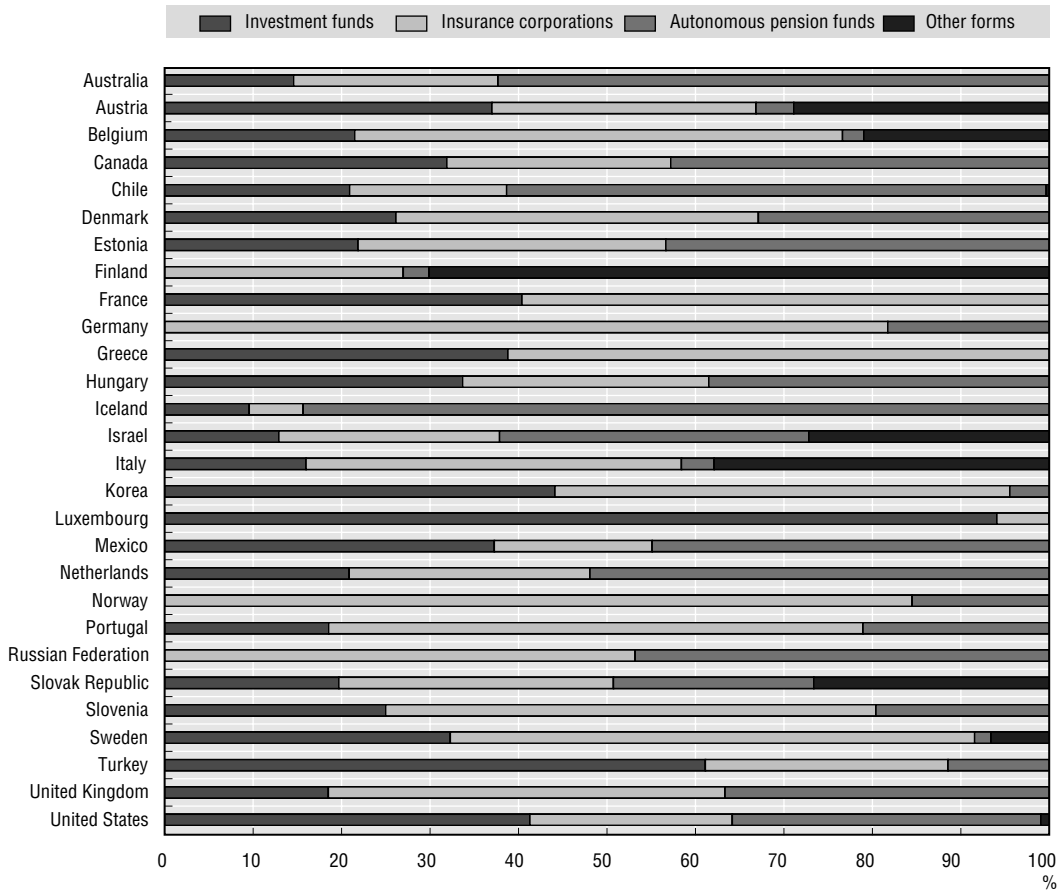
Source: OECD, *Institutional Investors Database* (*http://stats.oecd.org/index.aspx*).

Figure 1.5. **Percentage of assets held as "shares and other equity" by type of institutional asset owner**



Source: OECD, *Institutional Investors Database* (*http://stats.oecd.org/index.aspx*).

Figure 1.6. **Share of financial assets held by institutional asset managers in 2009**



Note: The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Source: OECD, *Institutional Investors Database* (*http://stats.oecd.org/index.aspx*).

institutional investors. In countries like Greece, Luxembourg and Mexico, investment funds are major institutional investors. However, the statistics can be misleading. Thus in the UK and the Netherlands, pension funds often outsource to fund managers subject to investment mandates of around three years.

Official financial accounts consistent with the national accounts are not currently available for Argentina, Brazil, China, India, Indonesia, Hong Kong (China) and Singapore. The information that is publicly available indicates that Hong Kong (China) and Brazil have a large mutual funds sector, and the latter also has a large pension fund sector. The pension sector is expected to grow rapidly in China with the public pension fund (National Social Security Fund) entitled to 20% of proceeds from IPOs of state owned companies. The insurance sector is also expected to expand from its current level of USD 728 billion (Table 1.1).

Measured by assets under management, the funds management industry is dominated by US registered institutions. Table 1.2 would show even more concentration if account is taken of the fact that BlackRock has now acquired Barclays Global. It also shows how misleading the table could be since most of the fund managers have significant locally based operations such as Barclays Global that is now classed as a US registered fund manager. Institutional organisation varies widely thus an investment management

Table 1.1. **Financial assets by institutional investors in other jurisdictions**

Million USD	Mutual funds				Pension				Insurance			
	2007	2008	2009	Source	2007	2008	2009	Source	2007	2008	2009	Source
Argentina	6 789	3 867	4 470	ICI	30 000	30 000	30 000	IFSL/TCUK				
Brazil	615 365	479 321	783 970	ICI	288 000	288 000	288 000	IFSL/TCUK				
China	434 063	276 303	381 207	ICI			342 158	OECD ART			728 417	OECD ART
Hong Kong	818 421	n.a.	n.a.	ICI	65 000	60 000	68 000	IFSL/TCUK				
India	108 582	62 805	130 284	ICI2	62 000	62 000	62 000	IFSL/TCUK				
Indonesia	9 788	6 764	12 019	B-LK	20 676	19 036	29 834	B-LK	9 014	7 597	11 126	B-LK
Singapore					91 000	91 000	91 000	IFSL/TCUK	100 654	89 923	106 145	MAS
Saudi Arabia	28 024	19 949	23 881	CMA	13 279	7 386	10 346	PA				
South Africa	95 221	69 417	106 261	ICI	150 000	150 000	150 000	IFSL/TCUK				

Source: Investment Company Institute (2011), Supplementary Tables of Worldwide Mutual Fund Assets and Flows Third Quarter 2010, available at *www.ici.org/pdf/ww_09_10_sup_tables.pdf*; TheCityUK (2011), TheCityUK Research Centre, "Pension Markets", February 2011, available at *www.thecityuk.com/media/214429/pension%20markets%202011.pdf*; Monetary Authority of Singapore (2010), *Insurance Development Data*, available at *www.mas.gov.sg/resource/data_room/insurance_stat/2009/Insurance_Development_09.pdf*; CMA (2008), Capital Market Authority of Saudi Arabia, *Annual Report 2008*, available at *http://cma.gov.sa/En/Publicationsreports/Reports/CMA2008.pdf*; CMA (2009), "Capital Market Authority of Saudi Arabia", *Annual Report 2009*, available at *http://cma.gov.sa/En/Publicationsreports/Reports/CMA_finalENGLISH.pdf*; Pension Agency, Statistics of Public Pension Agency of Saudi Arabia, available in Arabic language at *www.pension.gov.sa/Resources/downloads/statistics/PPA_Statistics.pdf*, *www.pension.gov.sa/Resources/downloads/statistics/PPA2007.pdf*; *www.pension.gov.sa/Resources/downloads/statistics/PPA2008.pdf* and the questionnaire in the OECD Asian Roundtable on Corporate Governance (unpublished).

Table 1.2. **Largest global investment managers**

Assets under management, end- 2008			USD billion
1	Barclays Global Investors[1]	UK	1 516
2	Allianz Group	Germany	1 462
3	State Street Global	US	1 444
4	Fidelity Investments	US	1 389
5	AXA Group	France	1 383
6	BlackRock	US	1,307
7	Deutsche Bank	Germany	1 150
8	Vanguard Group	US	1 145
9	J.P. Morgan Chase	US	1 136
10	Capital Group	US	975
11	Bank of New York Mellon	US	928
12	UBS	Switzerland	821
13	BNP Paribas	France	810
14	Goldman Sachs Group	US	798
15	ING Group	Netherlands	777

1. acquired by BlackRock in 2009

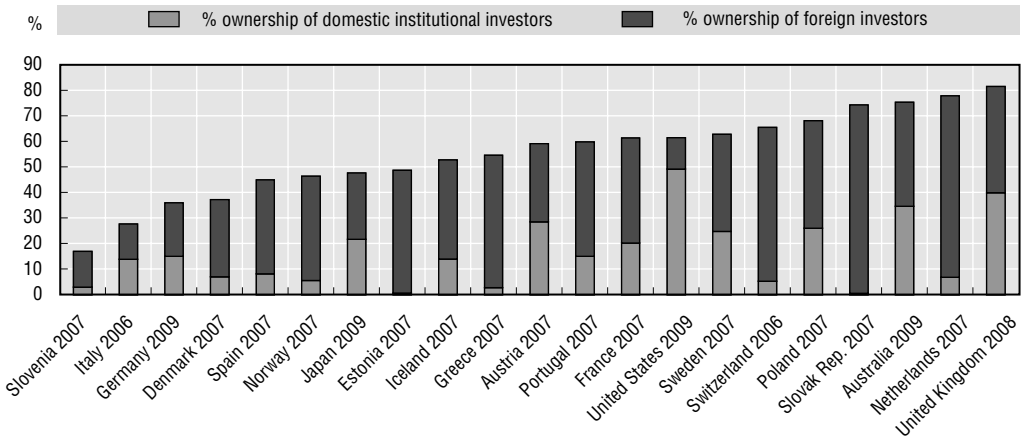
Source: TheCityUK (2010), TheCityUK Research Centre, "Fund management 2010", October 2010, available at: *www.thecityuk.com/what-we-do/reports/articles/2010/october/fund-management-2010.aspx*.

company in Germany only has one board overseeing a number of funds but in the US each fund has its own board. There are some 4000 individual equity mutual funds in the US, but management is highly concentrated: the top 5 mutual fund families have about 37% of all assets, the top ten have about 48% and the top 25 had 70% in 2006 (Taub, 2007).

1.2.2. Stock ownership by institutional investors

The ownership structure of companies varies widely across jurisdictions and with it the potential role and responsibilities of institutional investors. Thus Japan and Germany

Figure 1.7. **Ownership by domestic institutional investors and foreign investors in selected countries**



Source: Australia (2010), *Australian National Accounts: Financial Accounts*, September 2010 available at *www.abs.gov.au/AUSSTATS/abs@.nsf/DetailsPage/5232.0Sep%202010?OpenDocument*; Bank of Japan (2010), *Flow of Funds* (Fiscal Year), available at *www.stat-search.boj.or.jp/ssi/cgi-bin/famecgi2?cgi=$nme_a000_en&lstSelection=11*; Deutsche Bundesbank (2011), Time series database, available at *www.bundesbank.de/statistik/statistik_zeitreihen.en.php*; FED (2011), Federal Reserve Statistical Release, "Flow of Accounts of the United States", several years, available at *www.federalreserve.gov/releases/z1/*; FESE (2010), Federation of European Securities Exchanges, "Share Ownership Structure in Europe", December 2008, available at *www.fese.eu/_lib/files/Share_Ownership_Survey_2007_Final.pdf*; UK (2010), The Office for National Statistics, "Share Ownership Survey 2008", January 2010, available at *www.statistics.gov.uk/pdfdir/share0110.pdf.*

are not characterised by a high level of institutional investor ownership (under 50%), one having dispersed domestic ownership and the latter concentrated ownership (Figure 1.7).

Institutional ownership in China on the Shanghai Stock Exchange is around 50% with individuals accounting for 20%.[7] Institutional investors owned about 78% of the free float of which insurance accounted for 5%, investment funds 7% and the national social security fund (NSSF) the bulk of the remaining 64%. In India, institutional ownership is 17% overall but 25% in the large companies. The pattern of institutional investors focusing more on larger firms is a common phenomenon in a number of jurisdictions (Ferreira and Matos, 2008). In the US, UK and Australia, institutional investors are more important. Common in a number of countries is a declining individual shareholder base although in India (Table 1.3) and China they remain important.

Domestic institutional investors are important for the UK, the US and Australia. However, statistics for foreign institutional investors are marked by a key drawback for analytical work: the failure to distinguish between direct investment and foreign institutional portfolio investors. Thus in Figure 1.7 ownership is high in Slovakia, Ireland and Hungary due to a high level of foreign direct investment in these three small economies. On the other hand, in the Netherlands, Japan and the UK, the bulk of the figure is known to be institutional investors.

A sketch of the funds management industry would not be complete without noting that trading volumes on the worlds exchanges have increased leading to a decline in average holding period (Figure 1.8), albeit from a low level on some exchanges.

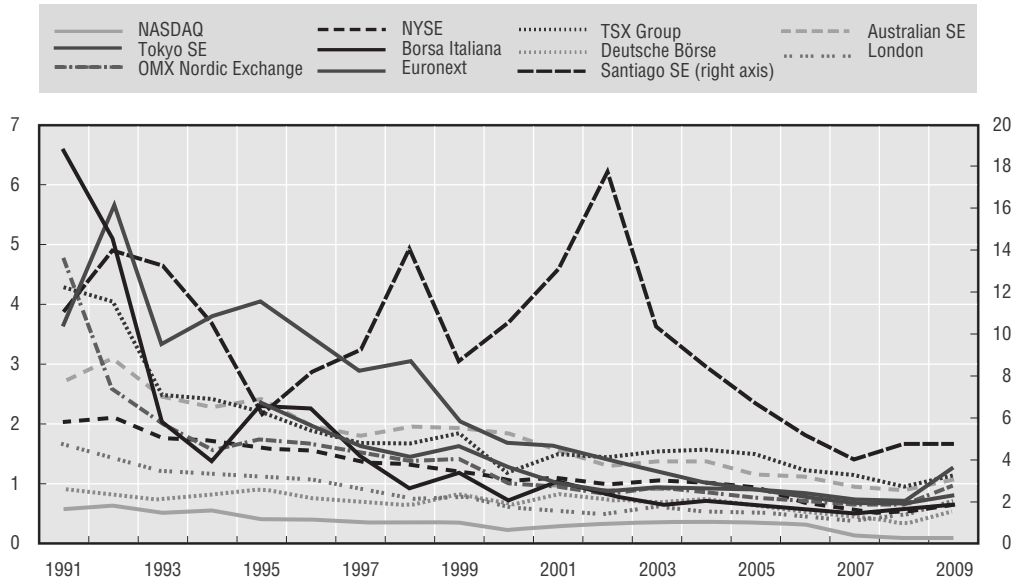
The market capitalisation of all stock exchanges increased during the period 1990/1991-2008/2009 in a range of 1.1-7.8 times, while trading value increased from 1991 to 2009 by 4.8-41.7 times. On all stock exchanges, the increase in the trading value exceeded that

Table 1.3. **Ownership structure of India**

	June 01	June 09		
	Avg. shareholding pattern for all companies listed in NSE	Avg. shareholding pattern for all companies listed in NSE	Nifty companies	Top 200 companies listed in NSE based on market capitalisation
Promoters				
Indian	39.65	50.93	41.22	44.23
Foreign	5.39	6.79	10.93	10.15
Person acting in concert	3.32			
Total promoter holding	**48.37**	**57.72**	**52.15**	**54.38**
Public				
Institutions				
Banks/FIs/Insurance Cos	7.99	5.68	9.79	6.44
MFs	4.83	3.27	3.75	5.06
FIIs	4.61	8.89	15.53	13.33
Any other		0.33	0.42	0.27
Total institutions	**17.43**	**18.17**	**29.49**	**25.1**
Non-institutional holders				
Individual	17.53	13.05	8.71	10.28
Corporate bodies	12.28	5.83	3.49	4.96
Any other	4.39	3.66	3.12	2.97
Total non-institutional holders	**34.2**	**22.54**	**15.32**	**18.21**
Shares held with custodians against which GDR/ADR issued		1.57	3.04	1.91
Total public holding	**51.63**	**42.28**	**47.85**	**45.22**
Total	**100**	**100**	**100**	**100**
Market capitalisation (in Rs.)	**USD 120 797 million**	**USD 917 547 million**		

Source: Indian response to the OECD questionnaire.

Figure 1.8. **Average holding period on major stock exchanges (number of years)**



Note: The average holding period is computed from the annual turnover ratio, that is, the average of the total market value at the start and end of the year divided by the total value of trading during the year.

Source: World Federation of Exchanges (2010a), Time series statistics of *Domestic Market Capitalisation*, available at *www.world-exchanges.org/statistics/time-series/market-capitalization*; World Federation of Exchanges (2010b), Time series statistics of *Value of Share Trading*, available at *www.world-exchanges.org/statistics/time-series/value-share-trading*.

of the market capitalisation by 1.7-9.9 times. As a result, the surge of trading implied a reduction in the average holding period.

Aggregate figures are nevertheless difficult to interpret but detailed information is scarcely available. Nevertheless, some information can be obtained from the Tokyo Stock Exchange on both value of stock holdings by different institutions and the value of turnover, though there are differing definitions. Table 1.4 clearly indicates the strategic investments of banks and private non-financial institutions (NFI) that are not used for trading. However, the period 2000-2003 would have shown a much lower average holding period as share portfolios of banks had to be reduced to 100% of capital by 2004 (OECD, 2003). The insurance industry, where strategic holdings are well documented, is also similar. The overall decline for insurance was probably due to their rebalancing of assets away from equity towards bonds. Thus the average holding period is very difficult to interpret. Foreign investors and individuals by contrast were more likely to trade.

Table 1.4. **Historical average holding period (years) by type of investors in TSE**

Year	Banks	Insurance	Private non-financial institutions	Foreign investors	Individuals
2004	26.11	33.45	18.07	0.89	1.51
2005	26.16	36.17	13.84	0.84	0.81
2006	33.79	45.24	13.54	0.65	0.77
2007	31.63	34.40	12.08	0.44	0.70
2008	23.33	18.98	13.32	0.35	0.74
2009	29.21	19.17	16.78	0.57	0.84

Note: The holding period was calculated from two sources, one for trading value by investor type and stock figures from an ownership survey by TSE. Therefore, the classification of investor type does not match entirely. For example, trading data was provided by large securities companies while ownership information was provided by share custodians.
Source: Tokyo Stock Exchange (2011a), *Statistical Database* on annual trading value, available at *www.tse.or.jp/english/market/data/sector/index.html*; Tokyo Stock Exchange (2011b), *Statistical Database on Shareownership Survey*, available in Japanese at *www.tse.or.jp/market/data/examination/distribute/index.html*.

A reason for the global decline in the average holding period might be due to the rise in high frequency trading by investor classes such as hedge funds that are not covered in the report. The Bank of England (Haldane, 2010) estimates that high frequency trading accounts for 30-40% of European trading in equities and futures. One reason for the increase in high frequency traders, apart from improved information technology, is the marked decline in transaction costs. Whether the global figures can be taken as evidence of short-termism is taken up in the following sections.

1.3. Codes, legal frameworks and disclosure requirements

Institutional investors are subject to widely varying levels of regulation and in a few cases must exercise fiduciary responsibility in voting their clients' securities. A great deal of the regulatory framework refers to prudential issues in the insurance, pension and mutual fund areas which is not the main subject of this report. However, they do affect investment strategies, which are closely related to their corporate governance responsibilities and actions as shareholders.

In recent years, a number of jurisdictions (ten in Table 1.5) have introduced professional codes of behaviour (*e.g.* UK, the Netherlands and Germany) to augment the

Table 1.5. **Summary of the status of the Principles**

Countries	Principle II.F.1		Principle II.F.2		Principle II.G	Institutional code
	Disclosure of voting policies-code C or law L	Disclosure of actual voting	Duties, fiduciary F, Loyalty L, general bans G	Disclosure of conflicts of interest	Yes but subject to concert/market abuse C, subject to other restrictions R	
Argentina	No	No	F	No. bans on some behaviour such as invest in owner	No special regulation	Investor protection code
Australia	C	Code	F	Code and general bans on some behaviour	C	Yes
Austria	No	No	G and F	No	C	No
Belgium	Partial, new EU dir	No	F	Not implemented but new EU dir	No information	Yes, asset managers
Brazil	No but in prospectus			No	Implemented, protection for proxy solicitation	Yes. fund managers
Chile	L	Yes	F	Policies needed but no disclosure	Yes subject to some concerns	No
Czech Republic	Code	No	L	Code	No special rules	Yes
Germany	C & L	No		Code and rules on conduct but no disclosure	C Restrictive.	Yes, complement to law. Asset managers
Greece	Code	No	F	Code	C	Yes
Hungary	No	No		Yes	Disclosure but no barriers	Yes, fund managers
India	Implemented	Yes-mutual funds	F	No but bans on some behaviour	C	No
Indonesia	No	No		No but some practices banned	No special legislation	No
Israel	L	No	F	Yes	Yes but subject to anti trust issues	No
Italy	UCITS. L	No	Regulation and code	Regulation and code	C. Being clarified	Yes, asset managers. Comply or explain
Japan	Recommendation	No		No rules or code	Implemented	Yes, Investment trust association
Mexico	No	No		No	No rules	
Netherlands	Code, comply or explain			Not specific but RPT exception	C	Dutch corporate governance code
New Zealand	No	No	F	No	C	
Poland	No	No		No	No regulations but also code	Yes, asset management
Portugal	C & L	No but divergence from voting policies	F and also laws against some behaviour	No but laws against behaviour	C	Yes, CIS and pensions
Slovak Republic	C & L	No		Collective investment law	Not known	Yes
Spain	L for relevant holdings	No	L	L once EU directive UCITS is in force	C but disclosure of non statutory shareholder agreements	No
Switzerland	L only for CIS. Might change for pension funds.		F &G	Disclosure for pension funds but not others	C	No but a private initiative Ethos
Turkey	No	No		No	No regulation Disclosure over thresholds	
United Kingdom	No but disclose whether they follow code: C & L	Legal powers but relying on code	F	No but code	C	Yes. Comply or explain. Stewardship Code
United States	L	Yes	F	Rules on behaviour but less on disclosure	Yes and disclosure rules	No

Source: Country Questionnaires and OECD Secretariat.

regulatory framework and the UN has also introduced its Principles of Responsible Investment. In addition, professional organisations such as the ICGN and the European Fund and Asset Management Association (EFAMA, 2011) have also made their own recommendations making for an extensive patchwork of recommendations, regulation and standards. By and large, the codes and the regulatory system cover many of the issues of transparency and duties specified in Principles II.F.1 and II.F.2. However, the level of compliance with codes is still not fully known.

For members of the EU, the situation will change appreciably with the implementation into local law of the new directive covering collective investment in transferable securities (UCITS). It requires management companies to develop adequate and effective strategies for determining when and how voting rights attached to the instruments held in managed portfolios are to be exercised to the exclusive benefit of the fund concerned. Article 21 calls for a strategy including measures and procedures for monitoring relevant corporate events, ensuring that the exercise of voting rights is in accordance with investment objectives and preventing or managing any conflicts of interest arising from the exercise of voting rights.

In most jurisdictions there is no explicit obligation to vote. In some others there is an obligation to vote for some types of resolution. For example, in Israel, a fund manager, pension fund and insurance company must participate and vote if the resolution could harm unit holders such as through approval of related party transactions and Switzerland is considering a similar requirement. The latter two institutions must also vote in the election of external directors. Some jurisdictions set thresholds for the need to vote. For example, in Spain, the obligation to vote is limited to those cases in which the value of shares is quantitatively significant and "temporarily stable".

It appears that more jurisdictions now require disclosure of actual voting (*e.g.*, Australia, US, India, Chile, and Spain after UCITS amendments and possibly also Switzerland) although investee companies are often not required to disclose the voting outcomes of their shareholder meetings. The UK authorities have the power to require institutional investors to disclose how they have voted but they have not been used to date. They are instead relying on adherence to the new Stewardship Code. By contrast to many other countries, the US relies on regulations to implement Principles II.F.1 and Principles II.F.2. These are described in Box 1.2. Chile, Germany and Australia, the three reviewed countries also have important elements of regulation which for the latter two jurisdictions underpins codes.

The concept of fiduciary duty or duties of investment managers more generally varies across jurisdictions depending on their legal traditions and is more developed with respect to pension fund trustees. For example, Spain and Mexico have a duty of loyalty (*i.e.* not to act against the interests of the investor) which covers conflicts of interest. In other countries there is more in the nature of a fiduciary duty to act in the best interest of the investors. In a number of jurisdictions, the duties are specified according to sector regulation.

An important development in a number of jurisdictions is the development of codes of behaviour, the latest one being the UK Stewardship code (Box 1.3) that was based on an earlier industry code by the Institutional Shareholders Committee. This arose in response to the financial crisis and the observation in the Walker Report (2009) that institutional shareholders had failed in the run up to the crisis. This hypothesis about lack of monitoring was also supported by Goergen *et al.* (2008).[8]

Box 1.2. **Corporate governance provisions in the US covering mutual funds and pension funds**

Under the US federal securities laws, registered **management investment companies (including mutual funds)**[1] are required to disclose to investors their overall voting policies with respect to their investments, including the procedures that they have in place for deciding on the use of their voting rights. The SEC regulates mutual funds, and its rules require disclosure of a mutual fund's overall policies for voting portfolio securities. Because a mutual fund is the beneficial owner of its portfolio securities, the fund's board of directors, acting on the fund's behalf, has the right and the obligation to vote proxies relating to the fund's portfolio securities. As a practical matter, however, the board typically delegates this function to the fund's investment adviser as part of the investment adviser's general management of fund assets, subject to the board's continuing oversight. The investment advisor to a mutual fund is a fiduciary that owes the fund a duty of "utmost good faith, and full and fair disclosure".

Mutual funds are required to disclose in their registration statements the policies and procedures that they use to determine how to vote proxies relating to securities held in their portfolios. Under this disclosure requirement, the mutual fund must disclose the procedures it uses when a vote presents a conflict between the interests of fund shareholders, on the one hand, and those of the fund's investment adviser, principal underwriter, or an affiliated person of the fund, its investment adviser, or principal underwriter, on the other. A mutual fund also must disclose any policies and procedures of the fund's investment adviser, or any other third party, that the fund uses, or that are used on the fund's behalf, to determine how to vote proxies relating to portfolio securities. For example, if a fund delegates proxy voting decisions to its investment adviser that uses its own policies and procedures to vote the fund's proxies, the fund must disclose the investment adviser's policies and procedures. If a fund's board chooses to adopt its investment adviser's policies and procedures, it also is required to disclose the adviser's policies and procedures.

A mutual fund also is required to file with the SEC and to make available to its shareholders, either on its website or upon request, its record of how it voted proxies relating to portfolio securities.

With respect to pension funds, a difference is drawn between private and public funds. In the United States, most private-sector pension funds are subject to the Employee Retirement Income Security Act of 1974 (ERISA), which sets standards of conduct for plan fiduciaries who manage plans or their assets.[2] Fiduciaries must discharge their duties prudently, solely in the interest of the plan's participants and beneficiaries, and for the exclusive purpose of paying benefits and defraying reasonable expenses of administrating the plan. Fiduciaries are also prohibited from causing the plan to engage in certain transactions and from using their authority or responsibility to benefit themselves. Plan participants also have the right to sue for benefits and breaches of fiduciary duty. An entity managing the plan is subject to fiduciary standards under ERISA in voting proxies.

The Department of Labor (DOL) interpretive guidance has indicated that the fiduciary duties generally require that, in voting proxies, the responsible fiduciary must only consider those factors that affect the value of the plan's investment and may not subordinate the interests of the plan's participants and beneficiaries in their retirement income to unrelated objectives. Votes may only be cast in accordance with the plan's economic interests. If the responsible fiduciary reasonably determines that the cost of voting (including the cost of research, if necessary, to determine how to vote) is likely to exceed the expected economic benefits of voting, or if the exercise of voting results in the imposition of unwarranted trading or other restrictions, the fiduciary has an obligation to refrain from voting.

Box 1.2. **Corporate governance provisions in the US covering mutual funds and pension funds** *(cont.)*

There is no requirement under ERISA that pension plan fiduciaries disclose how they manage material conflicts of interest that may affect the exercise of key ownership rights.

Neither ERISA nor the interpretive guidance issued by the DOL requires private pension funds to disclose their overall corporate governance policies with respect to their investments. There also is no requirement under ERISA to disclose the overall voting policies with respect to a pension fund's investment. However, DOL interpretive guidance has indicated that adopting a statement of investment policy to further the purposes of the plan and its funding policy is consistent with the fiduciary obligations and that a statement of proxy voting policy would be an important part of any comprehensive investment policy.[3]

Public pension funds are generally operated subject to state statutory and constitutional law, and accordingly the requirements applicable to the disclosure of corporate governance and voting policies, the fiduciary responsibilities and the requirements for managing conflicts of interests will vary from state to state.

1. Registered management investment companies include mutual funds (*i.e.*, open-end management investment companies). An open-end management investment company is an investment company, other than a unit investment trust or face-amount certificate company, that offers for sale or has outstanding any redeemable security of which it is the issuer. These disclosure rules also apply to registered closed-end management investment companies and insurance company separate accounts organized as management investment companies that offer variable annuity contracts.
2. Pension funds that are established or maintained by a governmental entity for the benefit of public employees are not subject to the fiduciary, reporting and disclosure provisions of ERISA. However, to the extent public pension funds provide their members with tax deferral on fund contributions and earnings, these funds must comply with the provisions of ERISA that are administered by the Internal Revenue Service (*i.e.*, provisions regarding non-discrimination, coverage, participation, integration with Social Security, benefit distribution, and operating for the exclusive benefit of plan members).
3. See Interpretive Bulletin.

Source: US response to the OECD questionnaire.

Box 1.3. **The UK Stewardship Code**

The overall objective is to enhance the quality of the dialogue of institutional investors with companies to help improve long term returns to shareholders, reduce the risk of catastrophic outcomes due to bad strategic decisions, and help with the efficient exercise of governance responsibilities.

Principle 1. Institutional investors should publicly disclose their policy on how they will discharge their stewardship responsibilities.

Principle 2. Institutional investors should have a robust policy on managing conflicts of interest in relation to stewardship and this policy should be publicly disclosed.

Principle 3. Institutional investors should monitor their investee companies.

Principle 4. Institutional investors should establish clear guidelines on when and how they will escalate their activities as a method of protecting and enhancing shareholder value.

Principle 5. Institutional investors should be willing to act collectively with other investors where appropriate.

Principle 6. Institutional investors should have a clear policy on voting and disclosure of voting activity.

Principle 7. Institutional investors should report periodically on their stewardship and voting activities.

Source: Financial Reporting Council (2010).

The European Commission Green Paper on Corporate Governance in Financial Institutions (2010) also indicates an interest by the Commission in stewardship codes noting that "shareholders lack of interest" in corporate governance raise questions in general about the effectiveness of corporate governance rules based on the presumption of effective control by shareholders of all listed companies. Similarly, engaging shareholders presents a real challenge for financial institutions. As of 31 January 2011, 108 asset managers had chosen to sign the UK Stewardship Code. The FRC (2010) estimates that they are responsible for over 40% of all assets under management in the UK. However, at least one author (Wong, 2010b) feels that the UK Code represents an unsatisfactory compromise between institutions with disparate conceptions of, and commitment to, stewardship.[9] In particular, the commitment to managing conflicts of interest is weak in an industry where they are common, so that a commitment to minimise them would be more appropriate. There is no mention of proxy advisors and investment consultants as well as the issue of share lending. There is no mention of investment management practices that encourage excessive trading and the attainment of short term returns and increasing intermediation. In this respect it is useful to compare it with the German BVI Code (German Association for Investment and Asset Management, 2005) that cautions against excessive churning of shares to gain commissions (see Germany review below).

The Dutch code for institutional investors (Box 1.4) is embedded in the general listed company corporate governance code and adherence must be confirmed by institutional investors on a "comply or explain" basis. However, it appears that this is not mandatory for investment fund managers and foreign institutional investors don't fall under its jurisdiction, an important omission given that foreign shareholdings are about 60% of Dutch equity. Follow-up research (Eumedion, 2011) on compliance found that indirect beneficiaries of institutional investors had no, or not much, interest in how the latter make use of their rights as shareholders Smaller institutions such as small pension funds showed low levels of compliance (50-60%) with the comply or explain provisions of the code of listed companies, but for large institutions this was in the range of 90-100%.

Box 1.4. **The Dutch corporate governance code's approach to institutional investors**

Since 1 January 2007, Dutch institutional investors are obliged to include in their annual report or on their websites a statement about their compliance with the best practice provisions of the Dutch Corporate Governance Code. The investor that has not applied a best practice provision has to carefully explain why (comply or explain).

Principle: Institutional investors shall act primarily in the interests of the ultimate beneficiaries or investors and have a responsibility to the ultimate beneficiaries or investors and the companies in which they invest, to decide in a careful and transparent way, whether they wish to exercise their rights as shareholder of listed companies.

Best practice provisions IV.4.1, IV.4.2, IV.4.3: Institutional investors shall publish annually, in any event on their website, their policy on the exercise of the voting rights for shares they hold in listed companies. They shall report annually, on their website or in their annual report, on how they have implemented their policy on the exercise of the voting rights in the year under review. Institutional investors shall report at least once a quarter on whether and, if so how they have voted at shareholder meetings.

Source: Tabaksblatt Commission website.

1.4. Co-operation between investors

The ability for institutional investors to co-operate is fundamental to resolving the free rider problems: one institution operating alone bears all the costs while the benefits accrue to all and there is no benefit to them incurring any costs of action. Hence the level of collective action might be sup-optimal. Table 1.5 indicates that laws generally allow institutional investors to co-operate although it is often subject to disclosure rules to prevent market abuse and to "acting in concert" provisions that underpin takeover laws. In other cases, proxy solicitation rules might be a key barrier, such as in the US and Canada for many years until reforms were introduced (see OECD, 2007). On the other hand, several jurisdictions do not appear to have any regulations which might also be problematic.

It is difficult to document the extent of co-operation between shareholders. However, one survey (McCahery, 2010)[10] found that 59% of respondents stated that they consider co-ordinating their actions. For the 41% of investors that did not co-ordinate, over half stated that it is primarily because of legal concerns: the risk of being deemed a group for purposes of Rule 13d-5(b) of Regulation 13D in the US or the risk of having to make a public offer for a company in the Netherlands if the joint holding exceeds 30%, similar to the law in Germany and in other EU countries. Interestingly, they also found that the most important trigger for shareholder activism is not dissatisfaction with a company's share price performance but rather with its (long run) corporate strategy. Around 80% of investors reported that they made positive/active investment decisions, pension fund managers being the lowest.

One report (IRRC, 2010) indicates that surveyed investors engage mostly alone, instead of collectively. However, a distinction was possible to draw between asset managers and asset owners (*e.g.* pension funds, trusts, etc.), where owners would engage more collectively than managers.

> "Part of this discrepancy between owners and managers may simply be a matter of asset managers competing with each other in a way that pension funds or other asset owners seldom do. Another explanation may be that asset managers, who are more likely to show up on a company's shareholder register than beneficial owners, are wary of triggering restrictions on 'acting in concert'." (page 8).

At the most general level, co-operation by institutional investors is already quite advanced. Thus in the Netherlands, Chile, Australia, Switzerland and the UK, private associations (sometimes loose as in Chile) of pension funds are proving very effective at spreading the costs of monitoring (and thereby reducing the free rider problem) by developing guides and background research. For example, Ethos in Switzerland, Eumedion in the Netherlands and ACSI (see Australia review in Part II) in Australia are three such organisations and also undertake background research and plan annual themes. They will also execute proxy votes for their members if requested. Public pension funds in the US (*e.g.* IRRC, 2011) and in the UK (Institutional Shareholders Council) also have similar arrangements. It is sometimes claimed that pension funds are more oriented to co-operation since they do not compete. This is, however, not true in Australia and in Chile where there is significant competition between them.

Co-operation between fund managers and mutual funds appears to be much less although private associations such as the International Corporate Governance Network (ICGN) are an exception. Some fund managers such as Hermes in the UK have also emerged as leaders which suits legal restrictions better. In the Australia review it is noted that there

is little collective engagement among fund managers due in part to fears of violating concert party regulations.

Co-operation is facilitated by the UN PRI's Engagement Clearinghouse (UNPRI, 2010) that provides signatories with a forum to share information about engagement activities they are conducting, or would like to conduct. It thus also seeks to deal with collective action issues and the problem of free riders. There are relatively few institutional investors in the world that have the power and legitimacy to individually influence corporate performance on ESG issues through the size of their own institutional shareholding alone. The scheme is based around a private online forum for signatories to pool their resources and influence, and seek changes in company behaviour, policy or systematic conditions. To use the PRI Engagement Clearinghouse, signatories develop a proposal for the engagement they would like to undertake, with details for how it would be conducted, expected outcomes, background information and any associated documents. Other signatories can see which activities are being proposed, and then choose to participate, or simply use the Clearinghouse as a learning platform. The UNPRI (2011) reports that from July 2009 to July 2010 a total of 223 signatories were involved in collaborative engagements promoted through the Clearinghouse and posted 85 new proposals up from 70 in 2008-2009. In relative terms, it is thus still quite small.

Around the world the implementation of Principle II.G appears to be difficult with respect to the provision "subject to exceptions to prevent abuse", especially with respect to takeover provisions (*i.e.* acting in concert). Both the German and Australian reviews point to significant legal uncertainty that sets a limit to investor co-operation. For example, in Germany investors should avoid discussing strategy which is not regarded as legally falling within their competence. In Australia there is a safe harbour, but it is claimed that it does not provide sufficient protection to shareholders engaging collectively on corporate governance matters. For example, the safe harbour applies only to voting actions, whereas engagements between shareholders and companies often encompass non-voting matters. The safe harbour also requires institutional investors to notify the regulator of collective activities whereas most engagements are highly informal and undertaken in private. The UK authorities have also sought to establish greater clarity as to when co-operation can be regarded as "acting in concert" and thus trigger takeover rules (FSA, 2009). The key issue is whether shareholders are attempting to obtain control such as via the appointment of non-independent directors (*i.e.* those employed by the investors). Discussing business strategy would not constitute per se acting in concert or seeking board control, unlike in Germany. In the case of Chile, on the contrary, the authorities seem to be at ease with the co-ordination and collective action of pension funds. Basically, the counterbalancing power of large controlling shareholders and the 7% cap to the shareholding of any individual pension fund in a company are deemed to mitigate the risk of abuse. In the majority of jurisdictions characterised by concentrated ownership and little in the way of a market in corporate control, a lot might be gained by pursuing a more relaxed approach to acting in concert.

In the US, which does not have takeover legislation, institutional investors are permitted to consult with each other in a meaningful manner in order to freely and effectively exercise their rights of share ownership. As in many other countries such as Switzerland, there are no restrictions on the ability of institutional investors to do so; however, their exercise of ownership rights and their collaborative activities may have implications with respect to their filing and beneficial ownership reporting obligations

(*i.e.* market transparency obligations). There are no provisions under the Advisers Act or the Investment Company Act that prohibit institutional investors from consulting each other regarding their basic shareholder rights. In addition, there are no express restrictions under ERISA that would prevent institutional investors from consulting each other on issues concerning their basic shareholder rights. However, the consultative activities must be prudent and solely in the interest of the plan's participants and beneficiaries.

The issue in the US of whether institutional or other investors have formed a group by virtue of their actions and interactions is one of facts and circumstances. The mere fact that institutional investors consult with one another regarding their ownership stake and resulting plans for an issuer may not be sufficient to form a group, without an affirmative act of coming together to behave collaboratively with respect to voting, holding or disposition of shares. However, a group may be formed without any express written agreement or plan. If a group is formed, filings may be required, but the consultations are not prohibited.[11]

Contacts and communications among institutional or other investors may implicate the US federal proxy rules, to the extent that a "solicitation" is present. Proxy solicitation rules in other jurisdictions also limit co-operation between shareholders (OECD, 2007).

1.5. Investment behaviour of institutional investors: the driving forces

The previous section has examined the status of the three key principles involving institutional investors: Principles II.F.1, II.F.2 and Principle II.G. However, even if all three principles would be fully implemented in all jurisdictions, which is clearly not the case, the question still remains whether they would promote good corporate governance in investee companies, or are they more in the way of a necessary but not sufficient condition. In other words, are the incentives and costs faced by institutional investors, in combination with disclosure and investor co-operation, sufficient to promote good corporate governance outcomes. The need to examine these broader questions was recognised at the time of the 2004 revision of the Principles through the introduction of Principle I.A: *the corporate governance framework should be developed with a view to its impact on overall economic performance, market integrity and the incentives it creates for market participants and the promotion of transparent and efficient markets*. This section describes some of the observed investment behaviour of institutional investors and relates them to the business models they have created and the costs and incentives they face.

The section first reviews what is known about investment objectives/incentive structures and then discusses various aspects of behaviour such as churning (buying and selling of the same stocks), index tracking and portfolio diversification. An important issue is addressed concerning the key criticism that institutional shareholders are short-term oriented, and therefore lead to suboptimal corporate governance outcomes. The issue of short termism is in many ways more macroeconomic: the short-term focus leads to the neglect of longer term projects by management which might raise growth. These arguments go beyond corporate governance considerations *per se* and into the area of growth and the operation of financial markets. It is this controversial area that raises issues concerning banks, capital markets, private equity and activist hedge funds dealt with previously by the OECD (OECD, 2007).

1.5.1. Objectives and incentives vary by institution and by country

Institutional investors covered in this report are concerned with the economics of their commitment to investors and the returns they need to meet these liabilities and to remunerate them for the use of their own resources, both human and financial. The business model varies across investment classes but only seldom does it depend exclusively or in good part on increasing returns from the companies in which they have invested *via* improved corporate governance and careful monitoring. Engagement is expensive and must be matched against potential revenues which are shared with other investors (*i.e.* there is a free rider problem). In the case of pension funds and insurance, a great deal will depend on the type of financial liability issued and the regulatory framework. For example, in a Defined Benefit scheme (DB) `the trustees can in theory, at least, seek to look at performance over the longer term and as such can accept more risk such as by investing in equities. Defined Contribution schemes (DC), by contrast, face a different liability structure and therefore a different attitude to risk and equities. As the TUC, (2006) points out, "much DC marketing makes a big point of the ability of members to change their investment regularly, and retail fund management advertising relies heavily on performance (page 33)". The steady shift away from DB to DC systems in many jurisdictions might lead to a shorter time perspective by individuals, and arguably less interest in additional management costs such as via engagement.[12] Much will of course depend on regulatory conditions which are often quite limiting such as restrictions on individual stock holdings which reduce incentives for engagement. Insurance companies are also limited by insolvency arrangements, which bias investments to shorter time horizons and to stocks which are highly liquid.

In many cases the institutional investor earns its revenues as a flat percentage of its assets under management which creates an incentive favouring rapid fund growth. Deviation from a targeted rate of return might end a mandate but seldom do fund managers receive a performance fee to encourage them to active management and to improvement in returns of investee companies. In many instances, as in the US, there are regulatory provisions defining allowable types of performance fees for mutual funds and public pension funds often have trouble competing for high level staff. One study (Kahan and Rock, 2006) calculated that the implied return from improved performance in a fund where the incentive scheme is oriented to the growth of assets is, under favourable assumptions, only some 3% of assets. A great deal will depend on regulation that can often determine which costs can be passed on to investors and those that have to be paid by the fund manager. By contrast, hedge funds in the recent past would earn about 20%. Hedge funds and private equity also have strong incentives to improve performance by the investee company and bonuses often have to be reinvested thereby sharing risks between the fund managers and investors (OECD, 2007). However, the review of Chile (see below) indicates that better incentive systems can be developed and implemented even for pension funds. Other jurisdictions might like to review their own incentives structures to see whether incentives to improved company performance via engagement can be better structured while maintaining prudential objectives.

In short, the business model and the incentive structures that are a part of it strongly influence the behaviour of institutional investors that is documented in this section. The issues are complex with competition in financial markets forcing institutional investors to monitor their revenues and costs closely. At the same time, externalities prevail through the free rider problem. The policy issue is what such markets imply for corporate

governance concerns in investee companies, voting behaviour and corporate monitoring more generally. In other words, does competition in financial markets including institutions with restricted incentive systems lead to socially optimal outcomes from the corporate governance or investee company perspective.

Institutional investors have heterogeneous views about investment objectives and about corporate governance mechanisms. For instance, one survey of investors in different jurisdictions (McCahery *et al.*, 2010) indicates that they have diverse preferences over governance mechanisms. The issue of most importance to the hedge funds in the sample was equity ownership by managers (*i.e.* alignment issues) whereas the issue of most importance to the insurance companies is a high free float (*i.e.* the possibility of liquidating shares easily). They therefore prefer large, liquid companies. Mutual funds regarded both equity ownership by managers and transparency about holdings of large shareholders to be most important. However, the most important triggers for shareholder activity were not corporate governance *per se* but dissatisfaction with the goals and strategy of a firm, planned acquisitions and corporate strategy in general. Share price performance did not appear to be the key driver. This is interesting given research indicating that acquisitions often fail.

Interestingly in view of the current public debate, in their sample about a half did not use proxy voting services at all and only 7% always used proxy voting firms for determining their voting decisions. Most used their external advice to help determine their own position. Moreover, as the sample of McCahery *et al.* covered fund managers with both investments in the US and the Netherlands, it appears that the funds realised that the optimality of certain board structures depends on country specific circumstances.[13]

The same survey supported other empirical work that institutional investors often consider exit rather than voice: 80% of investors were willing to sell shares in the portfolio company. A number of such block-holders selling shares might be very effective, especially if firms monitor (as recommended by some associations of company professionals) the transactions. The second preference of the sample is to vote against the company at annual meetings, some 66% of the sample saying that they would take this approach. Interestingly, 55% said that they would engage in discussions with the firms' executives and some 10% would even go public with criticisms. Thus, this wider category of institutional investors would undertake actions similar to those documented for activist hedge funds (see OECD, 2007). Most important, the study finds that investors who are more likely to be conflicted (*e.g.* private pension funds and some mutual funds) than those that could be considered more independent are less likely to engage in discussions with the executive board and to disclose their voting decisions (McCahery *et al.*, p. 25). This finding is in line with Ferreiro and Matos, 2008, and suggests significant conflicts of interest that actually change behaviour. Finally, the study does not show a strong relationship between the implied time horizon (as measured by the turnover ratio) and the propensity to shareholder activism: both "short term" and "longer term" investors are likely to engage in activism.

A study of shareholder activism in Germany in 2009 revealed that active shareholders' preferences strongly depend on the individual company and go further than narrowly defined corporate governance interests.[14] They included M&A activities and general strategic questions, as well as the composition and the remuneration of the supervisory

board (which are key corporate governance concerns), and capital policy (share buybacks and capital increases). There are strong pre-emption rights in Germany.

1.5.2. *Average holding periods*

Much is made of the fact that average holding periods for shares have fallen over time (Figure 1.8), it being taken for granted that investor time frames are shortening, which is *per se* a bad thing. However, it is not clear from this aggregate data whether this is a consistent phenomenon across asset owners or simply reflects a larger volume of turnover by a segment of the market, especially high frequency traders (usually hedge funds and securities firms).[15] High frequency program traders now account for some 30-40% of stock exchange trading in Europe and there are even higher estimates of 50-80% in both the US and in Europe.[16] Off-exchange trading might also have an effect since large packets of shares are said to be traded in this manner.[17] The Tokyo Stock Exchange has seen the greatest relative decline in average holding periods, but domestic banks and insurance companies have exhibited little change in their average holding periods (banks average holding periods, for instance, increased between 2004 and 2009 but probably fell in the preceding period as portfolios were rebalanced, see above) with much of the overall reduction driven by individuals and foreign investors.

It is a reasonable hypothesis backed by a great deal of anecdotal evidence that the average holding period is not saying that much about investor behaviour that is relevant to corporate governance concerns. It appears that a number of large institutional investors own relatively constant portfolios of shares measured at the beginning and end of a period but that they take advantage of market changes and short-term incentives to trade in an attempt to improve returns net of transactions costs. Thus index tracking discussed below might be compatible with only slowly changing portfolios but with trading during the course of the year. More research is required in this area.

One recent study examines the difference between planned and actual turnover rates. Of 822 fund strategies reporting expected and actual turnover between 2006 and 2009, 65% of them exceeded their expected turnovers by some 25% (IRRC, 2010). In some cases the difference was very large and could have had a significant impact on transactions costs and on whether fund strategy was being pursued. The average turnover was around 70% with some 20% of funds being above 100% (full turnover in a year or less). However, in the case of this study, it is difficult to overlook the sample period, which narrowly encompasses a period of historic volatility. Value strategies, large caps and responsible investment strategies all had lower turnover than their colleagues with other strategies.

Higher that planned turnover may be due to market volatility but in some jurisdictions it could also reflect the incentive system. Some respondents felt that three year mandates and periodic interim reviews of performance increased the perceived risk of losing a mandate and also pointed to mutual funds where managers are often incentivised against quarterly performance. “Less than 10% of managers have less than 33% turnover, the equivalent of a three year investment horizon, even though many investors consider three years to be a suitable time frame for showing performance over a market cycle” (IRRC, 2010).

1.5.3. *What is a long term investor?*

The debate about holding periods raises the profound question about how to define whether a “long term investor” is also a “long term engaged shareholder”; is it just about

holding shares or more about a point of view and a corporate presence (Kemna and van de Loo, 2009). This difference is crucial for considering policy options.

The notion that a long term engaged shareholder is about share *holding* is at the root of many policy proposals. Cross holding of shares as in Japan, France or Germany might lead to a long-term shareholder but does it make for an engaged long-term one when the motive might be to only block hostile takeovers? Of course there might well be other business motives with a long-term orientation such as an exchange of technology. Policy proposals addressed to share *holding* propose to compensate the shareholder for the supposed costs. Loyalty dividends and extra voting rights have been proposed and indeed in France shareholders holding shares over a period of two years have double voting rights.[18] However, loyal shareholders are not necessarily engaged shareholders. A loyalty dividend does not imply anything about engagement while double voting does not change the cost-benefit calculation by investors or at least only under specific circumstances.

There are good reasons why shareholders (or fund managers) might want to trade shares even if over the long run they might remain stable shareholders since they cannot sell the market. Average holding period data only offers few insights here. On the other hand, investment managers might sell shares for a number of reasons which might well be long term such as when the company implements a change in strategy that does not inspire trust.

The issue of high share turnover ("churning") is, however, an important one even if the ultimate beneficiaries remain stable in the longer run. Managements might be forced to take a short-term perspective and beneficiaries might end up paying excessive transactions costs. In part this is a private contractual issue and underpins work by, for example, the ICGN and others to develop a model mandate between asset owners and their fund managers (ICGN, 2011) and the German BVI Code described in Part II. However, it is also a regulatory issue (*e.g.* soft commissions, IOSCO, 2007).

What constitutes a long-term engaged investor cannot be answered without reference to the bigger picture and without reference to expectations. For those taking a stewardship approach, the duty of institutional shareholders will be ranked high and cannot be simply fulfilled by voting at company meetings. Portfolio investors will always appear short-term even if they hold the assets over a long period as might be required by an index tracking strategy. More important might be the perspectives of management and particularly by CEOs whose tenure has tended to shorten in many jurisdictions – and not just Anglo Saxon ones. This might be explained by the increased intensity of competition and by the fact that failed strategies might be apparent more quickly than in the past. It will certainly shorten the time perspective but is this short termism?

1.5.4. *Lengthening the investment chain*

An increasing number of intermediaries in the investment chain have been observed in many jurisdictions although the underlying reasons for this development are still not fully clear. The lengthening of the investment chain is well illustrated by the case in the Netherlands: in the first quarter of 2009, approximately 93% of Dutch pension assets were invested externally with one or more asset managers, while this percentage was still less than 50% in 2001 (Eumedion, 2010). Moreover, the average duration of the mandate that a pension fund gives to a manager is three years and the pension fund's decision whether to extend the mandate or not is partly based on the financial performance of the relevant

asset manager in this period, mostly against a benchmark. This can give managers a further incentive to pursue shorter term objectives, even if the overall portfolio might not change significantly. Moreover, the increased scale of many fund managers in the Netherlands means that they might be becoming distant from both the client and the ultimate beneficiaries, and from the company whose shares are held.

The length of the investment chain may not matter that much if it results in economies of scale by fund managers and is overseen by beneficiaries or their agents. The review of Australia (below) notes that the pension fund administrators do keep in close touch with fund managers but that this is only feasible given the relatively small number of listed domestic companies. However, elsewhere it is reported that many pension funds, with equities accounting for 70-80% of their portfolios, do not scrutinise the engagement activities of their passive managers (Wong, 2010a). In turn, the final beneficiaries of, for example, a pension fund may not follow closely the policy of its trustees, its fund advisors and finally the fund management company (see for example TUC, 2006).

1.5.5. *Index tracking and ETFs*

Index-based investment strategies and index-based products are now a well established segment of the investment management industry. Standard & Poor's reports that in 2010 there was USD 3.5 trillion benchmarked to the S&P 500 alone, including USD 915 billion in explicit index funds. Russel estimates that USD 3.9 trillion is currently benchmarked to its indices (Wurgler, 2010). Moreover Exchange Traded Funds now amount to some USD 1.2 trillion (Bradley and Litan, 2010). Given concerns about tracking errors, an active manager who is benchmarked to an index is likely to trade the stocks in that index. One researcher notes that it is impossible to determine the exact dollar value of US equities whose ownership and trading is somehow tied to an index, but the above figures suggest that trillions of dollars are involved. This means that every day billions of dollars in net flows affect index member companies but not excluded companies.

There are many financial issues related to the popularity of indexing including herding behaviour leading to volatility. However, this review is focused on corporate governance issues arising from this form of investing, and they are important although indirect. It is argued that index-linked investing is distorting relative stock prices and risk-return tradeoffs, which in turn may be distorting corporate investment and financing decisions, investor portfolio allocation decisions, fund manager skill assessment, and other choices and measures (Wurgler, 2010). Indeed, some companies, especially the newer growth stocks, often opt-out of indexes as a condition to being listed!

According to one estimate (Wurgler, 2010) a company chosen on the basis simply of its liquidity and market representation to participate in say the S&P 500 sees a price increase due to demand of some 9% as portfolio trackers reweight portfolios – and even more if the stock has been deleted. This is all independent of any changes in the company's prospects. Moreover, the stock price will track the other members of the index unrelated to its own performance and those of comparable stocks (*i.e.* its covariance with other stocks will change) (Box 1.5).

Institutional investors are believed to make heavy use of market indices such as FTSE 100, S&P 500 and the MSCI World Index. In addition, more specialised indexes such as those dealing with ESG or only with corporate governance are appearing all the time. In determining the mandate for investment managers, both internal and external, indexes

Box 1.5. **Effects of company inclusion in S&P 500 index**

The S&P 500 Index is a capitalization-weighted index. Each stock that is newly added to the Index must be bought by explicit index fund managers and others – and rather quickly so, because their mandate is to replicate broadly or exactly the Index.

Wurgler (2010) notes that "On average, stocks that have been added to the S&P between 1990 and 2005 have increased almost 9% around the event, with the effect generally growing over time with Index fund assets. Stocks deleted from the Index have tumbled by even more. Given that mechanical indexers must trade 8.7% of shares outstanding in short order, and an even higher percentage in terms of the free float, not to mention the significant buying associated with benchmarked active management – this price jump is easy to understand and, perhaps, impressively modest.

The obvious explanation for this jump is simple supply and demand. One might be able to argue that one component of the price jump is due to expected increases in liquidity (an impact distinct from fundamentals of the firm). However, changes in volume, quoted spreads, and quoted depth are much smaller than would justify a price increase of several percentage points. After all, these stocks were already selected by the S&P in part because of their high liquidity. (…)

If a one-time inclusion effect of a few percentage points were the end of the story, then the overall impact of indexing on prices would be modest. But the inclusion effect is just the beginning. The return pattern of the newly-included S&P 500 member changes magically and quickly. It begins to move more closely with its 499 new neighbours and less closely with the rest of the market. It is as if it has joined a new school of fish. It is worth repeating that this pattern is occurring in some of the largest and most liquid stocks in the world. (…)

These co-movement patterns are where the real economic impact starts. Just as the initial price jump is a result of sudden index fund demand for the new stock, the increased co-movement with other members of the S&P 500 is related to the highly correlated index fund inflows and outflows that they experience.

The net flows into index-linked products are both large and not perfectly correlated with other investors' trades. Indexers and index-product users are by definition pursuing different strategies from those of the more active investor. They are less interested in keeping close track of the relative valuations of index and non-index shares. Some are index arbitrageurs or basis traders who care only about price parity between index derivatives and the underlying stock portfolio. The upshot is that over time, the index members can slowly drift away from the rest of the market, a phenomenon I (Wurgler) will call 'detachment'."

Source: Wurgler (2010), pages 5-7.

are often used to set performance and indeed strategy. Passive investment managers are those who must match the index but often active investors will also be judged on their deviation from an index. An active fund manager whose portfolio gained 10% but the relevant index rose by 12% will have "underperformed". The advantage of passive investing, through for example, a mutual fund is that transactions costs are lower than with active investing.

The potential significance of passive investors can be gauged from a Towers Watson study that predicts that over the next ten years, the proportion of institutional investor

asset allocation to passive investing will increase from 25-33% to 50% (as quoted in Wong, 2010a). In 2009, passive assets rose by 62% to USD 7.3 trillion. Towers Watson noted that "passive investment management remains a growth business as more institutional investors have concluded that their governance arrangements are stretched thin in overseeing the successful active management of their assets and have added to their core" (Towers Watson News, 2010).[19] Establishing a tracking mutual fund could of course include the commitment to engage with companies in the prospectus. This is regarded as a potential policy option in some jurisdictions.

There can be several negative features of indexing from the viewpoint of good corporate governance. First, there is a danger of "invest and forget" even for corporate governance or ESG indices. In theory a passive investor could always generate excess returns from the market average (indeed it is the only way) by engaging, subject of course to costs. This is, for example, the position of the UNPRI (2011). However, the empirical question is, do they actually monitor their portfolio companies? One large investor told the OECD that it is an index tracker. However, this fund was also an important activist investor and saw the two strategies as not in conflict. Similarly, it is reported that the two largest index trackers in the UK market, Legal and General and BlackRock, argue that their inability to sell compel them to be more interested in company engagement. This is underpinned by them taking a 4% to 5% stake in listed companies. Chilean pension funds showed a similar approach on the domestic equity market (see review below).

Back in 1991, Lowenstein already pointed out that indexing had obvious advantages as a way to reduce heavy brokerage commissions and advisory fees charged by active investment strategies that seldom proved to beat the indexes anyway. Industry wide, he stressed, it is impossible to escape a return to the mean as the gain made by one investor is the loss of another. Easy access to a diversified portfolio was another upside of indexing. But Lowenstein also pointed to several doubts as to the functioning of indexation, concluding that "in a capitalist system there is no substitute for capitalists", and that indexed funds presented a high risk of passive shareholding that would deteriorate corporate governance at companies.

Second, the MSCI World Index consists of more than 1 500 companies which will need to be bought by an index tracker. Such a portfolio runs the danger of making engagement impractical and reduces the ownership of companies to being merely commodities.

Third, if a narrow time interval (*e.g.* quarterly) is used to measure success of investment managers there is a danger of short-term focus and heard behaviour (Wong, 2010 c). Rather it is suggested to lengthen the performance review period and reduce emphasis on market indices to gauge asset management performance. For example, the Marathon Club (2007) recommends annual reviews and reviews of portfolio holdings against the investment philosophy. They also suggest examining internal rates of return for exited investments.

Exchange traded funds are growing rapidly. The question that cannot be answered definitively at this stage is to what extent they will be used by institutional investors and what it might mean for engagement. As with indexes, much depends on the detail about how they are structured. For example, it is understood that one large sponsor, BlackRock, has maintained monitoring of the companies in its portfolio comprising a number of its ETFs. This might be due to the tradition of company engagement from the old Barclays Global team that it bought. Another large sponsor does no engagement at all. One market

participant (Wong, 2010) noted the case of one ETF provider that had decided not to charge any management fees but instead to rely on securities lending to generate income. From the corporate governance viewpoint this could be a negative development although the issue of borrowing shares to vote remains controversial as an empirical phenomenon[20] (Box 1.6).

Box 1.6. **Exchange traded funds: What are they?**

One critique of the widening use of ETFs is that they circumscribe the traditional price discovery role of the exchanges where individual stocks are traded. This is similar to the criticism of indexation.

ETFs were first developed to accurately track the performance of a portfolio. This enables asset managers to remain largely passive since as in a mutual fund they do not own any of the stock. The advantages of an ETF over an indexed mutual are lower commissions and, especially in the US, tax advantages.

The sponsor of an ETF such as BlackRock first determines the basis for an ETF and acquires or borrows these securities. The ETF might be based on a market capitalisation index such as the S&P 500 which avoids rebalancing risk. However, ETF sponsors have now moved into highly specific indexes and industries and these companies might not trade on liquid markets and so could prove difficult to liquidate.

The sponsor engages an Authorised Participant which is responsible for creating new ETF units. It also organises the secondary market and often provides the trading platform. A major participant is Susquehanna Financial Group which notes that at all times an AP can create more ETF units. Thus they can eliminate short exposures (Bradley and Litan, 2010 – page 3).

ETFs can be created to meet increasing demand or even redeemed. Creating ETF units consists of inputting (like warehousing) baskets of stocks comprising the index in large quantities – usually enough to make 50 000 ETF shares (so called creation units) that match the underlying index composition. The redemption process consists of accepting a basket of shares of the underlying units in exchange for creation units. No cash changes hands. Authorised participants (*i.e.* Brokers) are permitted to execute such trades at the end of the trading day. The creation and redemption process often eliminates any differences between the price of the ETF and the Net Asset Value.

Unlike a mutual fund, an ETF unit is not a claim to a fixed proportion of the underlying shares but is a derivative based on such shares. Turned around the other way, the value of a company share can be determined not by trading in that share but in trading the whole ETF. Arbitrage will force the price to follow that implied by the ETF valuation. The prevailing price of an ETF is not necessarily the cumulative net asset value of the underlying securities as in a mutual.

1.5.6. A high level of diversification

A marked feature of the institutional investor landscape is the common strategy of holding a very large number of companies in portfolios. For example, Wong (2010a) notes that one UK pension fund held shares in most of the 700 plus companies in the UK All Share Index and another US fund held 5 000 equity holdings in the US alone. One sovereign wealth fund holds shares in 8 000 plus companies globally. One reason for such large holdings is due to index tracking but another is also in some cases prudential regulations

that limit exposures to individual companies. In some cases regulations quite purposely deny institutions such as pension funds and insurance from exceeding a low percentage of shares in individual companies. Some institutional investors have also pursued diversification to reduce volatility risk even though some studies show that the objective to reduce portfolio volatility diminishes rapidly after 20-50 stocks (as quoted by Wong, 2010a). Either way, it makes engagement difficult and weakens the link to good corporate governance through company monitoring.

Some investors are undertaking changes although they may not represent a large proportion of the industry. Thus Wong (2010a) notes that two large investment funds are contemplating shrinking their equity portfolios from 4 000-5 000 holdings to 300-400 holdings, and in the UK a large investment house abandoned the practice of replicating or "hugging" market indices several years ago and today takes sizeable holdings in a small group of companies. It is reported that other investors are turning to such an approach. In Chile (see Part II) the pension funds can hold up to 7% of the equity of a company which, combined with co-operation between them, gives a significant voice. This is suitable in a market where exit is not a viable option.

1.5.7. The responsible investment movement: ESG issues

A major feature of the institutional investors' landscape in recent years is the advent of ESG investing as an asset class, primarily as a result of the UNPRI Principles (Box 1.7). The UNPRI process involves asset owners and asset managers, in total around 500 institutions. Most of these signatories classify themselves as active managers although over 85% of asset owners have at least some funds that are passively managed. In their recent report, the UNPRI reports progress in implementing their Principles. However, being a mixture of governance, environment and social factors it is difficult to determine the economic drivers. However, some observations are useful. Thus they note that "in the global market as a whole, ESG integration is being implemented across 8% and 6% of listed equities in developed and emerging markets respectively" (UNPRI, 2011). Over 4 000 extensive engagements run by internal staff were reported by signatories. Approximately 90% of signatories were involved in formal or informal collaboration with other investors on ESG issues and more than 35% collaborated to a large extent.

Box 1.7. **UN Principles for Responsible Investment**

Principle 1. We will incorporate ESG issues into investment analysis and decision making processes. The integration of ESG issues can be defined as using ESG research and analysis and/or screening potential investments based on ESG criteria in order to improve the portfolio's financial performance.

Principle 2. We will be active owners and incorporate ESG issues into our ownership policies and practices. This principle encourages signatories to take a stewardship approach, vote in an informed way at company meetings or on boards, and engage with investee companies and other entities in order to improve ESG performance.

Principle 3. We will seek appropriate disclosure on ESG issues by the entities in which we invest. For signatories to be able to implement Principles 1 and 2, they need companies and other entities to provide date on ESG performance, impacts, risks and opportunities. Until the disclosure of such data becomes standard practice in global markets, investors need to use their influence to drive transparency and disclosure from theirs investees, either directly or via third parties.

Box 1.7. **UN Principles for Responsible Investment** *(cont.)*

Principle 4. We will promote acceptance and implementation of the Principles within the investment industry. The Principles were designed to be a framework for the whole investment industry, and Principle 4 signatories to help spread responsible investment throughout the investment chain.

Principle 5. We will work together to enhance our effectiveness in implementing the Principles. Many ESG issues are too large and too complex for any one signatory to solve on their own. Therefore collaboration – through forums like the PRI Clearing house, PRI work streams and other industry initiatives – has become a key part of responsible investment implementation. Working together can increase the influence that investors bring to bear on investee entities, and being able to raise issues with other investors in a company is vital to sending unified signals on the importance of managing ESG issues appropriately.

Principles 6. We will each report on our activities and progress towards implementing the Principles. The issue of transparency and reporting is of increasing importance to investors and applies to both an investor's policies and how they are implemented. It is core to Principle 6 that investors report on how they put the Principles into practice. From 2012, greater transparency requirements will be introduced by the PRI initiative.

Source: UNPRI (2010).

1.6. The voting and engagement record

Actual voting and engagement practices are described in this section. A key overarching point to bear in mind is that such activities do not come cheaply. For example, the California Public Employees Retirement System spends USD 1 billion on external asset management fees which include tens of millions on governance funds. They are apparently under pressure to scrutinize such outlays as is the New York City public employee pension funds schemes that oversee USD 113 billion in funds (Global Proxy Watch, 2011). They have recently dismissed three external asset managers that have lost money after fees over six years.

1.6.1. Engagement with investee companies

The Principles call for institutional investors (and others) to "make informed use of their shareholder rights and effectively exercise their ownership functions". Codes and public discussion often go further and call for "engagement" or "stewardship". What do these actually mean in practice? Do they imply the same behaviour and responsibilities for different types of investors?

The recent UK Stewardship Code defines engagement to include pursuing purposeful dialogue on strategy, performance and the management of risk, as well as on issues that are the immediate subject of votes at general meetings (See Box 1.3). It clearly states that institutional shareholders "are free to choose whether or not to engage but their choice should be a considered one based on their investment approach", since institutional investors as agents have a mandate to fulfil. The annotations for Principle 3 of the UK Stewardship Code recommend that "investee companies should be monitored to determine when it is necessary to enter into an active dialogue with their boards. This monitoring should be regular, and the process clearly communicable and checked periodically for its effectiveness." What happens in practice at the moment in the UK is not known.

However, a recent study conducted by the IRRC Institute (2011) has documented the engagement practices of US corporations and shareholders. The study shows that "engagement between issuers and investors is common and increasing both in terms of frequency and subject areas", with a majority of the respondents saying they are engaging more than before 2007.

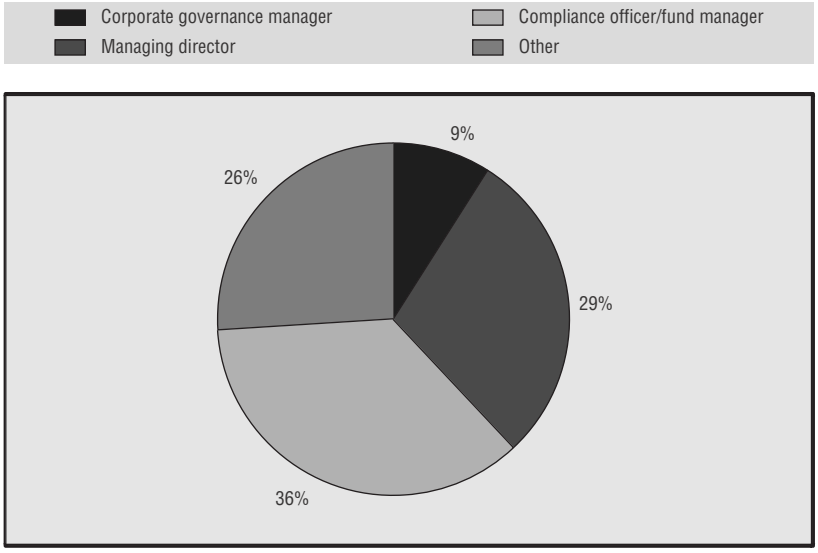
The IRRC report describes that increased engagement has been fuelled by: *i)* a greater awareness by institutional investors regarding risk at their portfolio companies following the recent financial crisis, as well as growing unease about the performance of boards overseeing management; *ii)* key regulatory changes that as a result of improved disclosure have prompted shareholder interest for comparable information and provided them with "greater visibility into company financials, potential conflicts of interest involving officers and directors, and compensation practices"; and *iii)* a favourable approach from issuers to the benefits of engaging with shareholders, as it may help them to address early potential issues or deal with existing ones "before they reach a boiling point".

Among the key findings of the report, it describes that a majority of respondents have internal research and monitoring teams, with between two and five people involved in engagement. However, they may not have the final say. Thus a German survey (DSW, 2008) points out that it is often the case that decisions on voting are not made by these people but rather by a managing director or a compliance officer (Figure 1.9). Institutional investors can also have conflicts of interest that can interfere with any research: Cohen *et al.* (2007) analysed a dataset of private pension plans in the US (401[k] retirement plans) and found that they were overweight in the shares of their client (the sponsoring company) even when the shares underperformed.

The IRRC report also shows that most investors engage alone, instead of collectively with other institutions. The report also shows that most engagements involve executive

Figure 1.9. **Voting decision making authority**

Who is responsible for the decision how to vote the fund's shares?



Source: Deutsche Schutzvereinigung für Wertpapierbesitz e.V. (DSW) Newsletter, April 2008, available at *www.dsw-info.de/uploads/media/Newsletter11.pdf.*

compensation issues and almost exclusively with domestic issuers.[21] But responses also reveal "that engagement also means different things to different people: While some use the term to refer to a campaign to persuade a company to change its behaviour, others (particularly issuers themselves) classify routine conversations with investors about financial results as engagement as well". However, the study also concludes that most engagements remain private and only few cases reach high-profile cases (see Australia review below).

1.6.2. Voting practices

The Principles approach voting from the perspective of shareholders' rights, rather than as one of their obligations. Nevertheless, they do call for institutional investors to disclose their "overall corporate governance and voting policies with respect to their investments, including the procedures that they have in place for deciding on the use of their voting rights" (Principle II.F.1).

Voting is an obvious form of engagement and the natural means for shareholder to manifest their preferences and exercise their voice. Most jurisdictions either mandate some institutional investors to vote (*e.g.* US, Box 1.8) or encourage them to do so as part of their fiduciary duties. A recent study estimates, by measuring the difference in the prices of the stock and the corresponding synthetic stock, that the mean annualized value of a voting right would be 1.58% of the underlying stock price (Kalay *et al.*, 2011). It also shows vote value increases around meetings with a high-profile agenda as well as for M&A events.

ICGN[22] has recently highlighted that in their view:

> "for long-term investors to exercise their voting rights effectively, particularly on contentious or material issues, engaging with companies before the general meeting is invaluable. Voting at general meetings is not an end in itself: it should actually be viewed as a form of stewardship which prompts engagement rather than a form of engagement itself. Voting against management without prior engagement essentially blunts voting as a stewardship tool and is likely to be counterproductive and less likely to result in companies making changes particularly where investors have concerns."

Principle III.A.4 states "impediments to cross border voting should be eliminated" and Principle III.A.5 notes that "processes and procedures for general shareholder meetings should allow for equitable treatment of all shareholders. Company procedures should not make it unduly difficult or expensive to cast votes."

In practical terms, the exercise of voting rights in some jurisdictions operates as an impediment to effective engagement, and jurisdictions are making efforts to streamline the processes involved in exercising these rights. A study (MPRA, 2008) examined several legal and economic obstacles to institutional investor activism in the EU and in the US, concluding that there is a lower voting presence of investors in the EU that may be due to the difficulty of accessing proxy voting and a degree of apathy derived from the small stakes they own in the foreign companies.

Impediments are particularly visible with respect to cross-border voting, especially with the increasing prevalence of foreign institutional investors in most markets. In Europe, the Shareholder Rights Directive (2007) seeks to facilitate cross border voting but difficulties still remain, as it did not address some of the technical barriers and is still not fully implemented by national jurisdictions. One study of cross-border voting in Europe

Box 1.8. **Main proxy voting obligations under US laws and regulations**

Investment Companies (including mutual funds, closed-end funds, and exchange-traded funds) and their advisers have obligations with respect to proxy voting, many of which stem from specific requirements under the Investment Company Act of 1940 and the Investment Advisers Act of 1940. The major proxy voting obligations include:

- A fund's board of trustees, acting on the fund's behalf, is responsible for the voting of proxies related to the fund's portfolio securities. The fund's board normally delegates voting responsibility to the fund's adviser, subject to board oversight, in recognition that proxy voting is part of the investment advisory process.
- Federal law imposes a fiduciary duty on a fund's adviser, and this duty extends to proxy voting. An adviser that votes a fund's proxies therefore must do so in the best interests of the fund and its shareholders and without regard to the adviser's own business interests. Thus, when voting proxies on a fund's behalf, the adviser must not be influenced by its other business interests, such as whether it manages or administers a 401(k) plan for the company whose proxies are being voted.
- Funds and their advisers must establish and disclose written proxy voting policies and procedures. Among other things, these policies and procedures must specify how the interests of fund investors will be protected when a vote presents a conflict between the interests of fund investors and those of a fund's adviser. A fund's board must review these policies at least annually.
- Funds must "recall" loaned securities to vote proxies. Funds frequently enter into securities lending programs to generate extra income, thus increasing their total return. Because the right to vote proxies passes to the borrower of the securities, funds must terminate these loans and recall the securities on loan in time to vote proxies if funds have knowledge that a material event affecting those securities will occur.
- Unlike other shareholders, funds must disclose all the proxy votes they cast. They do this by filing Form N-PX with the SEC, which must be filed each August.

Source: Investment Company Institute (2010).

(Manifest Information Services, 2007) concluded that the obstacles can be attributed to market issues, problems at the issuer level, and inefficiencies caused by the chain approach to voting (Box 1.9).

Among the reasons explaining the difficulties of cross border voting, Manifest (2007) points to the sheer inefficiency of the chain of intermediaries through which voting instructions must pass, with additional time required by each member in the chain, adding to a total that means that the end investor has no real time to decide how to vote. The report explains that "the logistical challenges faced by cross-border institutional engagement on a large scale, combined with the continued significance of passive investment strategies, means that voting has far from lost its place as a prime means of engagement in general". The results of the study point also to the fact that very few investors are able to know with certainty that their cross-border voting instructions are actually carried out at the meetings. The aggregate meeting poll data is the best information they can currently obtain as to how the resolutions were voted, having to satisfy themselves with an assumption that their voting instructions were received and carried out. Only some jurisdictions in the OECD area require companies to publish voting results (Manifest, 2011 and ISS, 2010).

Box 1.9. **Main obstacles to cross border voting in Europe**

Market issues that impede effective voting in Europe include: *i)* share blocking; *ii)* re-registration requirement; *iii)* requirement for a power of attorney; *iv)* existence of bearer shares; *v)* inadequate meeting notification periods and methods of distributing meeting information; *vi)* lack of provisions for distance and, specifically, electronic voting; *vii)* lack of recognition of electronic signatures; *viii)* voting restrictions; cumbersome registration process; etc. Some market issues can only be resolved by legislation. In view of this, the European Commission's Shareholders' Rights Directive was welcomed by all the participants in the study, as it aims to remove some of the above impediments to voting and encourage the introduction of more effective systems (*e.g.* the record date system) by obliging EU member states to change their company law.

Practices of issuers that are considered by institutional investors to be precluding foreign shareholders from participating and voting in company meetings include: *i)* Non-compliance, or compliance with only minimum legal requirements for meeting notification periods (where such periods are obviously short); *ii)* Publication of meeting notices in media easily accessible only to domestic shareholders; *iii)* Setting voting deadlines and other pre-meeting deadlines as early as allowed by law, or long in advance of the meeting, if there is no legal provision to this respect; *iv)* Introducing complicated meeting attendance requirements (*e.g.* share blocking or cumbersome registration procedures, etc.), where there is no statutory obligation to do so; *v)* Limitations on the appointment and powers of proxies, where these issues are left to the company's discretion; and *vi)* Non-permission of distance voting, where it is not prohibited by law.

The inefficiencies in the voting process caused by the chain approach are indentified as: *i)* lack of sufficient and meaningful information long in advance of the meeting; and *ii)* stock lending activities around the annual general meeting (separate annual general meeting and dividend dates are recommended).

Source: Manifest Information Services (2007).

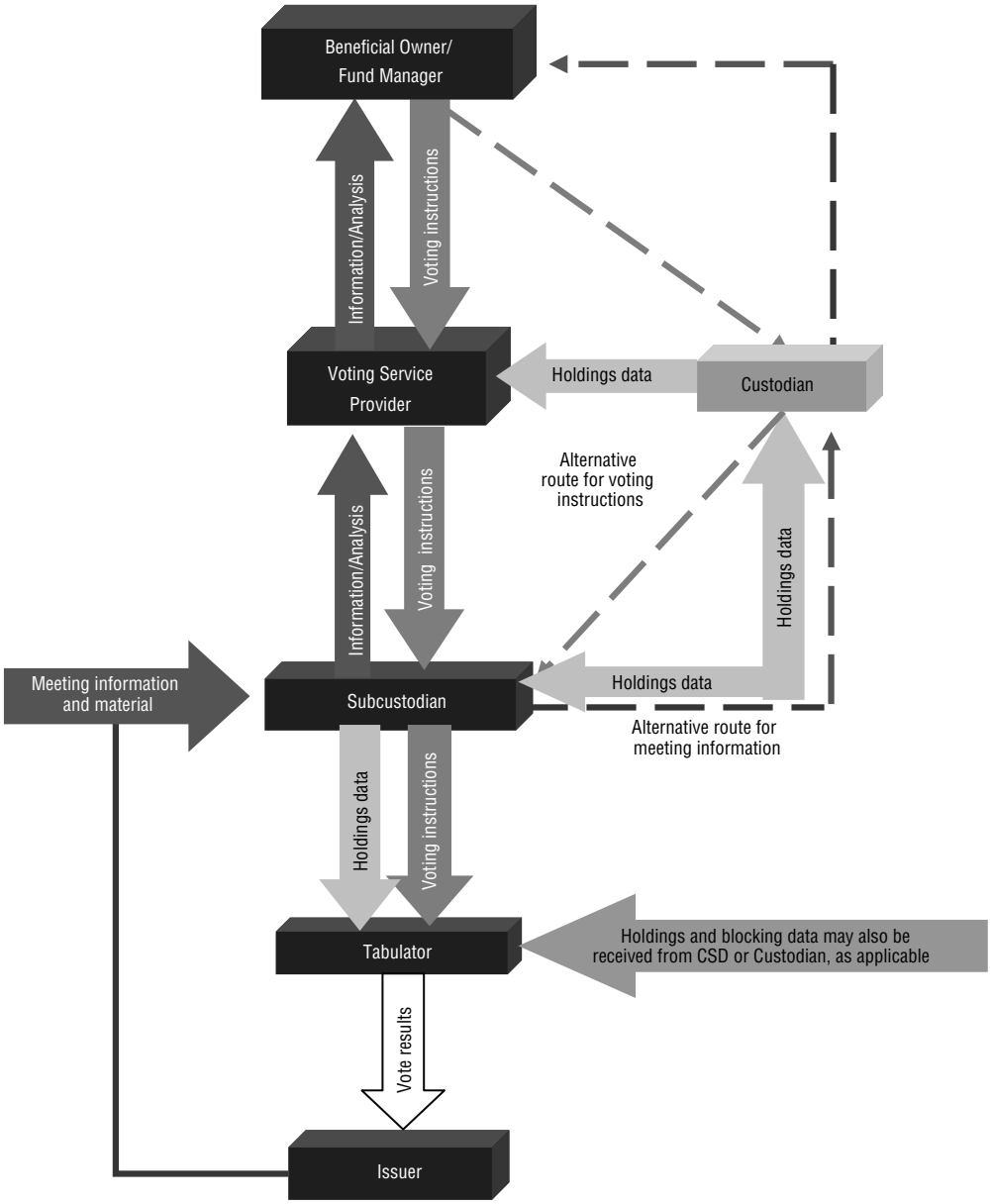
Manifest has made a diagram illustrating the complexity of the voting chain (Figure 1.10). It shows what is called a "very simplistic representation of the voting process, involving only one beneficial owner/fund manager, one global custodian, one sub-custodian and one voting service provider". The "more realistic" chart involves dozens of agents and intermediaries with all kinds of cross-links between them, that makes the entire picture look like the chemical representation of a very complex molecule.

A study examining general overall patterns of voting behaviour among shareholders across OECD member countries was commissioned from Manifest for this report (Paul Hewitt, Manifest Information Services, 2011). It tabulated the results of votes cast at shareholder meetings to assess the degree to which investors use their voting rights (an engagement tool) to register their concerns with companies on key corporate issues.

The results show that the analysis of voting patterns is much more complex than it would at first appear.

> "Analysis of the role of major shareholders is made very difficult without specific additional disclosure as to how each major or regulated shareholder has voted at a meeting. This is information which could be reported in the meeting minutes, as is the case in Chile.[23] In this way, it would be possible to ascertain the role of major

Figure 1.10. **Voting process in Europe (simplified)**



Source: Manifest Information Services (2007), Cross-Border Voting in Europe: A Manifest Investigation into the Practical Problems of Informed Voting Across EU Borders, May 2010.

shareholders in deciding meeting business. It would also serve to encourage in a more efficient way, collaborative engagement as it would enable shareholders to identify other potentially influential shareholders who might be sympathetic to their cause in order to work together to better leverage change."

Improving disclosure of voting records may be an area of future policy consideration (Box 1.10).

In terms of turnout, the Manifest study shows that the average meeting turnout per country, is about 63%, with only a minimal difference between general and special

Box 1.10. **Disclosure of voting records**

There is little public information about the actual outcome of voting procedures and the information provided not always allows for statistical analysis. Turnout figures are often not revealed (only percentages or approval or rejection), voting data is incomplete (only describing the votes of some investors, like institutional investors) or described in general "passed or failed" terms (not showing number of votes in favour or against), or not disclosed on a resolution by resolution basis.

To the extent that this information is significant to regulators and governments, especially with the high degree of inter-connectedness and interdependency which characterises today's financial markets, such lack of transparency might be viewed as surprising. Only comparatively recently that European regulators have attempted to take a co-ordinated approach to ensuring such information is made available as a matter of course. In general terms, countries in the Anglo-Saxon tradition have a better history of disclosing meeting results information, whereas developing and emerging markets tend to be characterised by lack of disclosure.

The importance of disclosure of meeting results is already enshrined in supra-national initiatives such as the European Shareholder's Rights Directive in 2007 (Article 14) and features in some other jurisdictions around the world:

> "The company shall establish for each resolution at least the number of shares for which votes have been validly cast, the proportion of the share capital represented by those votes, the total number of votes validly cast as well as the number of votes cast in favour of and against each resolution and, where applicable, the number of abstentions. […]
>
> Within a period of time to be determined by the applicable law, which shall not exceed 15 days after the general meeting, the company shall publish on its Internet site the voting results established in accordance with Paragraph 1 [above]."

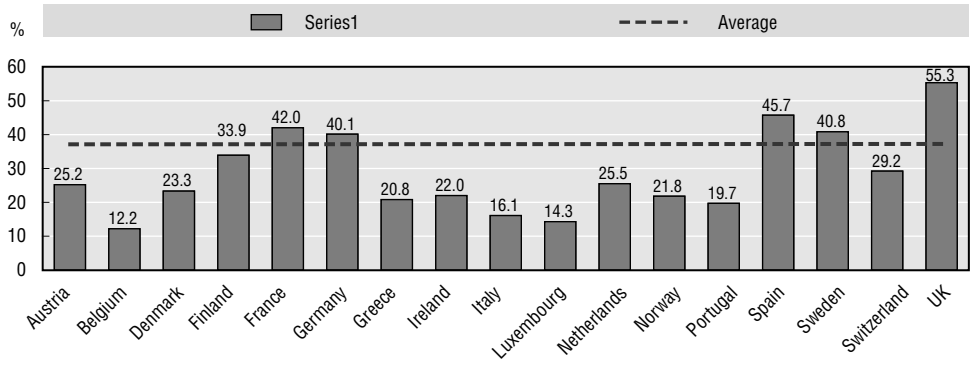
Source: Paul Hewitt, Manifest Information Services (2011).

shareholders meetings. The US is an outlier in the sample with a high 81% average turnout despite a large foreign shareholding and dispersed ownership, characteristics associated with lower averages. Two systemic explanations are offered: *i)* the practice of allowing brokers, which are a significant player in the US, to vote "non-instructed" shares under their street name; and *ii)* ERISA laws, pursuant to which institutional investors, especially mutual funds and pension funds, view it as mandatory to vote their shares.

A recent ISS report on voting in Europe (ISS, 2010) arrives at similar conclusions, showing an average turnout of 61.5% for 2010. Interestingly, it also tries to assess whether the minority shareholders exercise their voting right by estimating the turnout among minority shareholders on the assumption that all relevant large shareholders voted. The results show that considering only the shares of investors owning less than 5% of the stock of companies, the average turnout would be around 37%. They conclude that there is a general disinterest that is exacerbated by the presence of block holders that cast more votes than all voting minorities put together (Figure 1.11.).

Manifest suggests that turnout levels can be just as good an indicator of institutional engagement as the degree of "dissent" expressed on resolutions. Both show the proportion of investors for whom it is deemed important enough to bear the cost of voting their

Figure 1.11. **Estimated minority shareholder turnout in Europe**



Source: Institutional Shareholder Services (ISS) (2010), ISS 2010 Voting Results Report: Europe, September 2010, available at *www.issgovernance.com/policy.*

shares, if that is not mandatory. Voting is after all one of the main engagement tools available to shareholders. But the report suggests that there are several reasons why it should not be viewed as the main measure of the quality of the dialogue between companies and shareholders:

- As institutional share ownership has grown, direct engagement between large shareholders and boards has also increased. These private forms of engagement shape the types of proposals presented at meetings and turn voting results into a rather limited sample to examine the degree of investor activity. As one Chilean pension fund manager mentioned in an interview conducted for this report, "most meetings are a waste of time, I never attend them but send a very junior staff member that knows exactly was has already been agreed, and makes sure things go just like that".
- Blind voting is also a practice that hinders the quality of engagement. There is no real communication between shareholders and companies when votes are automatically or mandatorily cast as a response to a "real or perceived" regulatory requirement to vote. Investors may be more interested in showing that they voted than on the content of the decision, with the result that they may well opt to issue "standing instructions" to always vote with management. This is a practice that Manifest claims is especially difficult to prove, precisely because professional investors cannot afford to be seen to be doing the "bare minimum".
- High levels of cross border investment may also be a factor leading to low turnouts or low levels of dissent in meetings, as explained above.

The Manifest report also shows remarkably low levels of dissent, both at general and special shareholder meetings. For general meetings, the average dissent level was only 3.5% across over 16 000 resolutions, with a maximum of 6.2% for Israel, and only 2.6% across 911 resolutions proposed at special shareholders meetings. The ISS Report on Europe shows a similar 3.7% average dissent for 2010 (ISS, 2010).

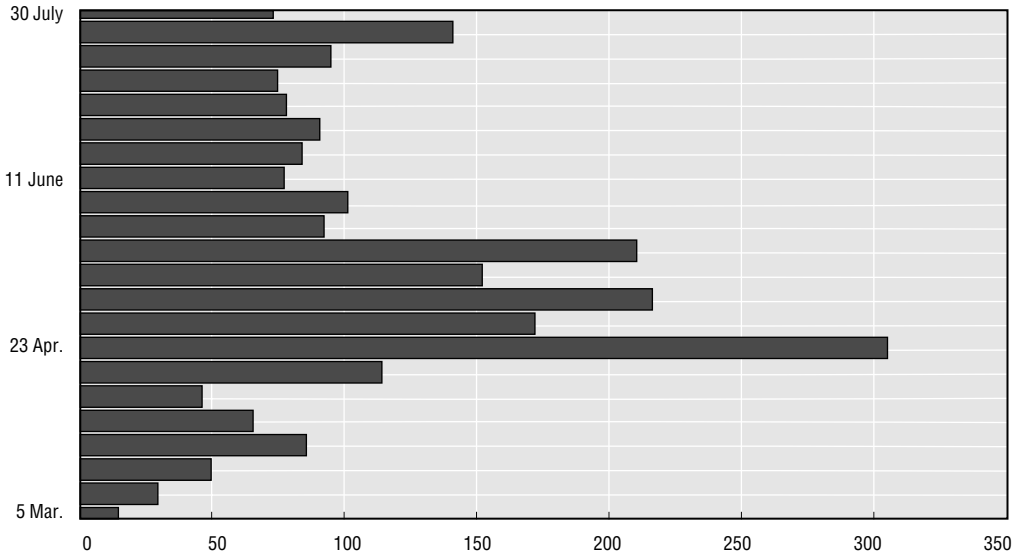
Most of the dissent votes had to do with remuneration. Research conducted by ICI examining 10 million votes placed by institutional investors in the US between 2007 and 2009, arrived at similar findings (ICI, 2010). It showed that dissent was lower than 10% and mostly related to shareholder rights and executive compensation issues (mostly say-on-pay proposals). At the same time, it shows that approval of proposals made by other shareholders (as opposed to management) had risen among these investors from 25% in

2007 to 50% in 2009, and that one of the most approved resolutions was to call for special meetings.

The Manifest study also noted that voting shares has a cost for the investor, so that a cost/benefit analysis will always take place. Key issues will likely be the perceived or actual regulatory obligation to vote; the perceived strategic importance of a given meeting, either in the long or short term, the degree to which investors demand voting as a part of the investment processes; the administrative costs of voting at meetings (especially when they are part of global custody services); and the reputational costs of being seen as passive.

Figure 1.12. **Clustering of shareholder meetings in Europe**

European meetings 5 March-6 August period (excl. GB)



Source: Manifest Information Services (2007). Cross-Border Voting in Europe: A Manifest Investigation into the Practical Problems of Informed Voting Across EU Borders, May 2010.

Adding an extra layer of complexity to voting, many markets have a tradition of clustering all general meeting in just a few weeks of the year, and sometimes there is a significant overlapping among jurisdictions as well, resulting in weeks when more than 80 meetings would take place only in Europe. Manifest reports that in those periods "investors' governance and proxy teams are usually stretched to the limit, and have less time to deal with each company meeting than they would have outside of the peak season" (Figure 1.12). In Japan the concentration of meetings on only around two days makes the situation extremely difficult for shareholders and their agents.

There is also an issue with voting by custodians and the related issues of share-lending. Principle III.A.3 notes that "Votes should be cast by custodians or nominees in a manner agreed upon with the beneficial owner of the shares". The annotations to the Principles note that the trend in OECD countries is to remove provisions that automatically enable custodian institutions to cast the votes of shareholders. This has happened in Germany (see German review). The German law also requires custodian institutions to provide shareholders with information concerning their options in the use of their voting rights. In the United States, the Dodd-Frank Act amended the Exchange Act to require the rules of each national securities exchange to be amended to prohibit brokers from voting

uninstructed shares on the election of directors, executive compensation, or any other significant matter, as determined by the Commission. What is not clear yet, but often an issue, is disclosure by institutional investors of their policies on lending securities and recalling lent shares.

1.6.3. The role of proxy advisors

The use of proxy advisors and voting services has been pointed out as one practical approach to complexities in cross border voting as well as in relation to large and diversified portfolios. These agents provide mainly two services: *i)* they analyse the proposals and documents to be considered at the shareholders meeting and advise investors on how to vote, and *ii)* they provide the logistics to actually cast the votes.

> "Depending on the service provider, the actual exercise of the voting rights can take place in accordance with the institutional investor's prior instructions to vote in conformity with a voting policy drafted by the investor himself (unless there are specific instructions to deviate from that policy) or to always vote in conformity with the service provider's own guidelines" (Verdam, 2006).

By recommending investors about whether to approve or reject proposals at shareholders meetings, proxy advisors may significantly facilitate the investors' decision making, while exercising strong influence on the market. Verdam (2006) points out that most investors tend to follow their advice, first of all, because it is easier from an administrative perspective "for 15 to 20% of ISS' clients the votes are cast automatically – so without any further action being required– in conformity with ISS' recommendations" (page 4). In addition, it would require the investor conducting its own research to conclude differently, and would have to "justify and render account both to themselves and to their beneficiaries why they are going against the advice of the expert called in by them" (page 5). Verdam cites research that has shown that 40% of the votes cast by institutional shareholders for shares in US-listed companies are in conformity with ISS' recommendations.

But proxy advisors' recommendations are not exempt from debate. The question many studies ask is how do they reach their recommendations? Among the issues debated is whether they analyse company proposals on a company by company basis or rely upon their policy position for the corresponding type of proposals and whether they consider national conditions or vote from a foreign perspective.

> "It looks as if proxy advisors let themselves be chiefly guided in their recommendations by policy lines which are highly thematic in nature and which have first been abstracted from the individual companies that they concern" (Verdam, page 7).

Some proxy advisors are willing to adopt the voting policy of their clients and issue recommendations based on those parameters. Verdam also notes that ISS declared to the SEC that in 2003 it had 320 "distinct voting policies" for its voting services, but also that informal inquiries from ISS showed that about two thirds of clients would be satisfied with ISS standard voting policy. Clients are given a chance to respond to questions and ISS takes their answers into consideration when deciding on their proxy advice. By 2005, it is reported that only 13% of ISS clients would respond, and that about 70% of the responses would come from the US alone. In Australia, as shown in the review below, institutional investors demand that their own policies are used by their proxy advisors.

Some proxy advisors explain that they base their recommendations on their own corporate governance ratings of companies. Studies of those ratings show that some metrics are correlated with company performance, but that in general they are far from being able to predict firm performance (Robert Daines, *et al.*, 2010 and Sanjai Bhagat *et al.*, 2008). Ratings firms "offer a profusion of proprietary rating systems, each constantly tweaked and recalibrated-a process that could be described as 'methodology churn'. No two are alike". Rose (2011) argues that poor-quality ratings are damaging corporate governance and, citing Bebchuk, 2009, concludes that they are more useful "to spot 'bad governance' structures than it is to effectively prescribe 'good governance' structures."

Conflicts of interest are another concern with institutional investors delegating their voting decisions to proxy advisors. Principle V.F. recommends that "Analysts, brokers, rating agencies and others who provide analysis or advice which is relevant for decisions by investors should disclose any material conflicts of interest that might compromise the integrity of their analysis or advice".

In the US, a debate is in progress with respect to the adoption of new regulations for the Proxy advisory industry (Box 1.11). The Society of Corporate Secretaries and Governance Professionals (2010) wrote to the SEC in a consultation process asking that all proxy advisors should be required to register as investment advisors and that all investor advisors relying on proxy advisory firms should be required to oversee their recommendations and analysis. In the past, the US SEC (ISS, 2004) has argued that in accordance with their fiduciary duties, investment advisers should ensure that they "can make recommendations for voting proxies in an impartial manner and in the best interests of the adviser's clients. Those steps may include a case by case evaluation of the proxy voting firm's relationships with issuers, a thorough review of the proxy voting firm's conflict procedures and the effectiveness of their implementation, and/or other means reasonably designed to ensure the integrity of the proxy voting process."

Box 1.11. **Proxy advisors' conflicts of interest – a recent debate**

The US Department of Labor has proposed regulations broadening the definition of "fiduciary" under ERISA in order to expand the parties who can be sued for plan advice. That proposal has resulted in serious questions being raised about the fiduciary responsibilities of proxy advisory firms in providing advice to shareholders. Glass Lewis, the second largest proxy advisory firm, urged DOL to prohibit the ISS business model of providing consulting services to corporate issuers while serving as an independent advisor to institutional investors. Glass Lewis also recommended that ISS be required to provide more specific disclosure of its relationships with issuers in its proxy reports. However, Glass Lewis sought to exclude itself from the new rule, stating it is not "appropriate to include un-conflicted proxy research advisors like Glass Lewis in the revised definition of fiduciary". Yet, Glass Lewis is owned by the Ontario Teachers' Pension Plan, which has an ownership interest in many public companies, thus creating its own conflicts of interest. In addition, it provides no transparency as to its methodologies, while ISS provides at least some information.

Without directly responding to Glass Lewis, ISS filed its comments with the DOL. In an effort to justify the conflicts of interest problem in the proxy advisory industry, ISS stated "[t]he complexity of relationships among parties in the proxy voting chain means that the potential for conflict of interest is always present for all proxy advisory firms".

Source: Center on Executive Compensation (2011).

A 2007 US Government Accountability Office Report (GAO, 2007) concluded that the main source of potential conflict of interest for proxy advisors was the simultaneous provision of services to institutional investors and corporate clients. Proxy advisors "could help a corporate client design an executive compensation proposal to be voted on by shareholders and subsequently make a recommendation to investor clients to vote for this proposal". Also, companies could feel compelled to contract services from proxy advisors "in order to obtain favorable proxy vote recommendations on their proposals and favorable corporate governance ratings". A number of other areas of concern were also indentified.[24]

The Society of Corporate Secretaries and Governance Professionals letter to the SEC argues that in the current framework, proxy advisors not only have significant influence on voting, "but for many matters they have become the de-facto arbiters of good governance". It also adds that such influence is not always used to benefit shareholders and that proxy advisors act "without having any economic interest in the shares of the companies they vote and without being subject to any fiduciary duties to the beneficial owners of the shares for whom they are voting". By asking for more regulation, the Society seeks to promote transparency, reduce conflicts of interest, and "provide greater discipline in the way vote recommendations are determined, thereby ensuring that votes are cast in the financial best interests of the beneficial owners" (Society of Corporate Secretaries and Governance Professionals, 2010).

Notes

1. Activist hedge funds and private equity are also important although much reduced from when the Committee last investigated them in depth in 2006/2007.
2. Note that the US data includes shares issued by all US Companies, not just listed companies, hence the relatively high share of individual share ownership.
3. As an example of the latter, an institutional investor in one country buying a stock in another country may use a home country custodian, which in turn uses an account at a global custodian, which could then use a host bank to hold the shares, whose name may be that on the register.
4. This approach does not consider the role of banks and insurance companies which, it has been argued, have been key players in not only the development of Japan and Germany but also in their post war reconstruction. The "insider" model has received considerable attention in developmental economies and elsewhere.
5. Such hedge funds may of course affect corporate governance indirectly by influencing relative equity prices. These possible indirect effects are discussed in the report in the context of indexing.
6. The pool of assets forming an independent legal entity that are bought with the contributions to a pension plan for the exclusive purpose of financing pension plan benefits. The plan/fund members have a legal or beneficial right or some other contractual claim against the assets of the pension fund. Pension funds take the form of either a special purpose entity with legal personality (such as a trust, foundation, or corporate entity) or a legally separated fund without legal personality managed by a dedicated provider (pension fund management company) or other financial institution on behalf of the plan/fund members.
7. Derived from a speech by Shang Fulin at *http://data.cnfol.com/110114/104,1298,9164208,00.shtml*.
8. Georgen *et al.* examine directors' sales or purchases in their own companies to see whether new information was being conveyed to the market. As new information appeared to enter the market they conclude that institutional shareholder monitoring was inadequate.
9. The term Stewardship is also used by the UNPRI. Stewardship involves managing another person's property, financing and other affairs. In its newest use it refers to institutions looking after property for beneficiaries. It is controversial when referring to institutional investors. Thus Frentrop (2011) states that engagement as promoted in the UK Code would require investors "to give up liquidity, reduce portfolio turnover, endure long periods of relative underperformance, significantly concentrate portfolios and take much larger stakes in single companies". Accordingly,

Frentrop suggests that "he who promotes stewardship isn't merely asking for improvements in corporate governance. Stewardship implies and demands a whole new system of institutional investors and pension fund governance". Can an investor really engage with and have loyalty to hundreds of companies in its portfolio?

10. Based on 118 survey responses to funds active in both the US and in the Netherlands. The sample comprised 6% hedge funds, 8% insurance, 62% mutual funds 6% pension funds and 18% others.

11. Contacts and communications among institutional investors could also have implications under the Hart-Scott-Rodino Antitrust Improvements Act (HSR Act). Under the HSR Act, certain purchases of voting securities or assets may not be consummated unless certain information has been furnished to the Antitrust Division of the Department of Justice and the Federal Trade Commission, although the acquisition of up to 10% of the stock of a public company is exempt from HSR filing and clearance requirements if it is made solely for the purpose of investment. While the group concept for purposes of Section 13(d) of the Exchange Act does not apply in the HSR context, institutional investors may consider whether any actions, such as communications with other investors, could be considered to invalidate their investment intent.

12. The impact on asset allocation and risk appetite will depend on a number of country specific factors. For a review see Broadbent *et al.* 2006.

13. In particular, the data does not suggest that investors accustomed to a one tier board system in their home country will always prefer the same system when they invest. It is argued that with concentrated ownership, a two tier board structure has some advantages. In the Netherlands, firms can select either board structure, but the majority have remained with a two tier system apart from some large international companies.

14. Private study conducted by McKinsey for the Deutsches Aktien Institut as quoted in the German questionnaire reply.

15. Across exchanges several factors have reduced impediments and increased access to active trading, suggesting that the observed reduction in average holding times, may reflect more frequent trading of a small portion of the float. The factors that have contributed to more active trading include: tax reductions; switching to computer-based matching from open outcry systems, internet and computer based trading, and shrinking bid/ask spreads by using smaller ticks.

16. Haldane 2010 estimates the figure as 30-40%. Other industry sources are more in the range of 70% for both the US and Europe. For example, see *http://eschatonic.worldpress.com/2011/01/28/casino-world-high-frequency-trading/*.

17. In addition a great deal of trading is now taking place off exchange through so called dark pools. See Christiansen and Koldertsova, 2009.

18. "Common French practice is for shares to acquire double voting rights after they have been fully paid and registered continuously in the name of the same shareowner for specified periods of time, usually two years. When the share is either converted into a bearer share or transferred (except through an inheritance, division of property between spouses, or a donation by the shareowner to the benefit of a spouse or another eligible relative), the double voting right is automatically cancelled." (CFA Institute 2009, page 24) It should be recalled that this policy is a way of underpinning the idea of a "noyer dure", a strong group of loyal shareholders who will prevent takeovers.

19. It should be noted also that the 62% increase is overstated by the incorporation of BlackRock's passive assets of USD 1.7 trillion for the first time. The actual growth rate was thus some 30%, still impressive.

20. Some dispute that the actual use of borrowed shares to engage in empty voting is important and deserving the policy and academic attention that it has received.

21. Of those institutions that responded to the relevant question of the IRRC questionnaire, "11 of 42 asset managers and six of 25 asset owners stated that they engage with domestic issuers only". According to the report, this was attributed mainly to the fact that their portfolios tend to be dominated by domestic companies, but also to the lack of responsiveness to requests for engagement by foreign counterparts, and lack of familiarity with companies "particularly on the part of Indexed investors".

22. ICGN response to the UK Department for Business Innovation & Skills' consultation "A Long Term Focus for Corporate Britain", 14 January 2011, page 4. It also adds that for institutional investors and fund managers, the disclosure of their voting activities publicly "creates the perception that by being transparent they are fulfilling their fiduciary responsibilities". But ICGN also notes that this

can prompt blind voting, if only as a way to escape 'name and shame' lists of "passive" investors which "fail to capture the extent to which investors have engaged with companies prior to the vote and have encouraged changes."

23. In the case of Chile, all listed companies have to submit to the SVS the minutes of their shareholder meetings, including detailed voting data in respect of specified shareholders (regulated pension funds and those who are representing others at the meeting – the sub-custodian banks). However, those minutes are normally filed in physical form, and are not available on the company or the SVS websites, making the information very hard to research.

24. The *GAO Report* points out that several other situations in the proxy advisory industry could give rise to potential conflicts. Specifically it lists: *i)* Owners or executives of proxy advisory firms may have a significant ownership interest in or serve on the board of directors of corporations that have proposals on which the firms are offering vote recommendations; *ii)* Institutional investors may submit shareholder proposals to be voted on at corporate shareholder meetings. This raises concern that proxy advisory firms will make favourable recommendations to other institutional investor clients on such proposals in order to maintain the business of the investor clients that submitted these proposals. *iii)* Several proxy advisory firms are owned by companies that offer other financial services to various types of clients, as is common in the financial services industry, where companies often provide multiple services to various types of clients.

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PART II

In-depth Country Reviews on the Role of Institutional Investors in Promoting Good Corporate Governance

The following chapters provide detailed analysis of each of the three focus countries of the peer review: Australia, Chile, and Germany. The reviews are based on detailed questionnaire responses provided by the reviewed countries, together with independent research by the OECD including several missions.

For each country review the document describes the institutional investor landscape and then outlines the legal framework within which they operate and how they exercise their shareholder responsibilities. The transparency requirements are assessed along the lines of Principles II.F.1 and II.F.2 and the possibilities for co-operation in accordance with Principle II.G. The use of proxy advisors covered in Principle V.F is also described. Finally, policy conclusions are drawn for each country.

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PART II

Chapter 2

Australia: The Role of Institutional Investors in Promoting Good Corporate Governance

This review provides an objective description and analysis of existing institutional investor practices in Australia and their influence on the corporate governance practices of companies in which they invest. It examines different dimensions of institutional investor activism in Australia, including features of the institutional investor landscape, legal rules and other guidance relating to institutional investor responsibilities, and voting and engagement practices.

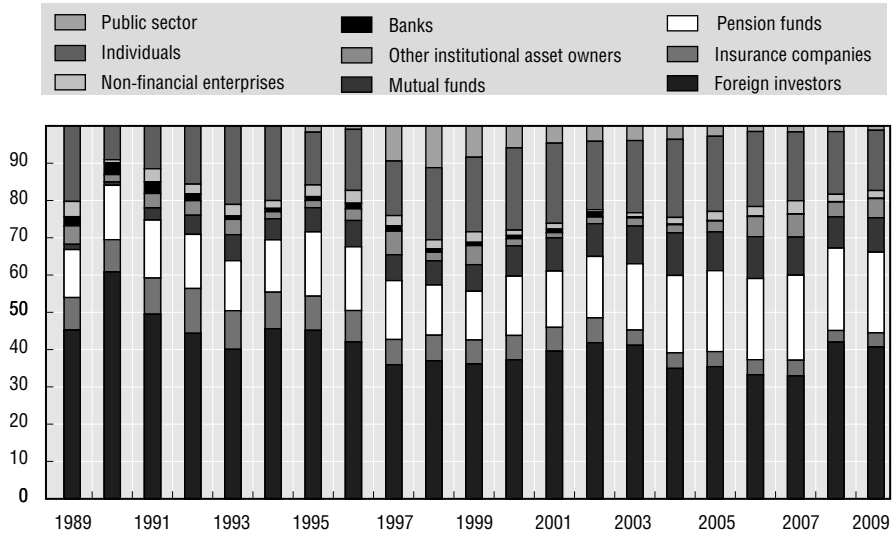
In recent years, Australian institutional investors have assumed a more prominent role in promoting good corporate governance in the domestic market. The catalysts for greater institutional investor involvement on corporate governance in Australia include the rapid growth of pension ("superannuation") assets, corporate collapses that brought about greater pressure on institutional investors to be active owners, and stronger shareholder rights. While institutional investors – particularly superannuation funds – have done more to instil good corporate governance practices, passivity and a lack of interest in this topic persist amongst many members of the institutional shareholder community. Moreover, there are impediments to the effective exercise of shareholder rights, although the problems in Australia appear less acute than in other markets.

This review provides an objective description and analysis of existing institutional investor practices in Australia. It examines different dimensions of institutional investor activism in Australia, including features of the institutional investor landscape, legal rules and other guidance relating to institutional investor responsibilities, and voting and engagement practices.

2.1. Institutional investor landscape

Mirroring the trend in many OECD member countries, the presence of institutional investors in Australia has grown in recent decades (Figure 2.1). In the 1990s, institutional investors' holdings in Australian companies amounted to 45-50% of the total stock market capitalisation. By 2009, this figure had increased to 64%.[1]

Figure 2.1. **Equity holdings by all types of investors**



Source: Australia Bureau of Statistics (2010), Australian National Accounts: Financial Accounts, September 2010 available at: *www.abs.gov.au/AUSSTATS/abs@.nsf/DetailsPage/5232.0Sep%202010?OpenDocument.*

In Australia, the two major categories of institutional investors are investment managers (including insurance companies) and superannuation funds. Investment managers, many of which serve the retail and institutional market segments, include domestic firms such as AMP Capital and Colonial First State as well as foreign houses such as BlackRock and Fidelity International. In terms of size, the Investment and Financial Services Association[2] (IFSA), an investment manager industry body, estimated that its members managed assets totalling AUD 1.1 trillion in 2009 (compared to Australia's GDP of AUD 1.3 trillion).

Superannuation assets have surged since the introduction in 1992 of the "superannuation guarantee charge" (SGC), which requires employers to contribute 9% of each employee's "ordinary time earnings" (*e.g.*, wages, bonuses, and commissions) into individual retirement accounts.[3] From a base of AUD 32.6 billion in 1981, superannuation assets grew to AUD 183 billion in 1993 and reached nearly AUD 1.3 trillion at the end of 2010 (Cooper Review 2010 and The Association of Superannuation Funds of Australia 2010).

The growth in superannuation assets will likely accelerate if, as expected, the Australian Government adopts a proposal to raise the superannuation guarantee charge to 12%.[4]

Superannuation funds are divided into five principal segments – corporate, industry, public sector, retail, and small funds (see Table 2.1).[5] According to the Australian Prudential Regulation Authority, these categories are differentiated as follows:

- **Corporate** – superannuation fund sponsored by a single or group of related employers for the benefit of company employees
- **Industry** – superannuation fund that draw members from a range of employers in a single industry. Industry funds currently exist in such sectors as construction and building, hospitality, and healthcare
- **Public sector** – superannuation fund where the sponsoring employer is a government agency or business enterprise that is majority-owned by the government
- **Retail** – for-profit superannuation fund that offers retirement products to the general public
- **Small** – superannuation fund with less than five members, including self-managed superannuation funds (SMSFs)

Corporate, industry, and public sector superannuation funds usually restrict membership, although some are open to the public. Retail funds are usually operated by large financial institutions, such as AMP, AXA, and Colonial First State.

Table 2.1. **Australia's superannuation industry (as at Dec. 2010)**

Sector	No. of funds	Assets (AUD billion)	Market share (%)
Corporate	162	58.0	4.80
Industry	65	237.7	18
Public sector	39	181.9	14.10
Retail	156	352.9	27.90
Small funds	438 194	409.6	32.00
Balance of life office statutory funds	n.a.	40.0	3.10
Total	438 616	1 280.1	100

Source: The Association of Superannuation Funds of Australia (2010), *Superannuation Statistics – December 2010*, *www.superannuation.asn.au/statistics/default.aspx*.

As Table 2.2 shows, corporate pension funds have shrunk dramatically over the past decade as companies have increasingly chosen to close their retirement schemes and transfer existing employee superannuation accounts to third parties such as retail and industry superannuation funds. In-house superannuation funds still exist at some large companies, such as Commonwealth Bank and BHP Billiton. Meanwhile, self-managed superannuation funds (SMSFs) have continued to grow, reaching 414 707 accounts in 2009.

Table 2.2. **Recent trends in the number of Australian superannuation industry by entities**

Sector	2003	2004	2005	2006	2007	2008	2009
Corporate	1 862	1 405	962	555	287	226	190
Industry	124	106	90	80	72	70	67
Public sector	58	42	43	45	40	40	40
Retail	235	232	228	192	176	169	166
SMSFs	262 175	286 313	303 004	323 200	361 860	389 308	414 707
Pooled Super Trusts	160	143	130	123	101	90	82
Total number of entities	264 614	288 241	304 457	324 195	362 536	389 903	415 252

Source: Super System Review Final Report (2010), "Cooper Review", *www.supersystemreview.gov.au/content/content.aspx?doc=html/final_report.htm*).

In addition, corporate, industry, and public superannuation funds have experienced varying levels of consolidation, fuelled principally by a desire to realise economies of scale. However, some mergers, particularly in the public sector, unwound subsequently due to differences in membership characteristics.

Since 2005, Australian workers generally have had the right to choose the superannuation fund into which their employer's contributions are deposited (although employers have continued to designate a default fund for their employees). As a result, superannuation funds compete with each other to attract members. For example, healthcare industry superannuation fund HESTA competes with other industry funds serving this sector as well as with retail funds.

According to a superannuation fund representative, the bases for competition among superannuation funds include breadth of investment offerings, fee levels, portfolio performance, and technology (*e.g.*, quality of website). In addition, each superannuation fund seeks to gain a competitive advantage by being designated as the default fund by companies.[6]

Most superannuation funds outsource all investment management to third-party investment managers. For some funds, such as State Super, internal management of retirement assets is prohibited by law. In recent years, a number of the largest superannuation funds – for example, Australian Super and UniSuper – have formed in-house teams to manage investments in such areas as fixed income, active Australian equities, and alternatives (*e.g.* infrastructure).

To help reduce costs and realise economies of scale, more than 30 superannuation funds – including HESTA, Cbus, Australian Super, and Vision Super – outsource some investment management to Industry Funds Management. IFM, which is collectively owned by its superannuation fund clients and managed AUD 23.4 billion as of

June 2010, offers listed equities, fixed income, private equity, and infrastructure funds. IFM is unique because it does not strive to maximise profits. Rather, according to an IFM shareholder, "IFM seeks sufficient excess earnings only to hire staff and develop new products".

In Australia, the institutional shareholder landscape also includes two influential industry bodies, IFSA and the Australian Council of Superannuation Investors (ACSI).

IFSA is the principal industry association for investment managers. Its members manage an aggregate AUD 1.1 trillion and own 25% of the shares of companies listed on the Australian Stock Exchange (IFSA, 2009). The organisation was founded in 1990 following the collapse of several Australian firms. Known initially as the Australian Investment Managers' Group, IFSA's principal objectives included (Hill, 1994):

- Advance the integrity of the Australian capital markets.
- Protect the rights of investors.
- Promote the interests of investors.
- Facilitate investors taking action when warranted by circumstances.
- Provide assistance to the Australian Securities Commission, stock exchange, and other government agencies in matters relating to investors' interests.
- Assist companies in understanding the requirement of investors.

Greater recognition by superannuation funds of their institutional responsibility led to the formation of ACSI in 2000. According to ACSI, the overriding objective of the organisation is to ensure that its members are "equipped to deal with governance risks in their investments in a practical way... consistent with their general duty to protect and advance the investments of superannuation fund members".

ACSI's membership comprises 39 superannuation funds with AUD 250 billion in funds under management. ACSI provides a suite of services to its members, including:

- Advise members on the governance practices of companies.
- Provide proxy voting services to assist members to exercise their voting rights efficiently and effectively.
- Engage with companies to improve governance practices.
- Commission and produce research to support its policy positions.
- Publicly advocate for improved governance practices and standards including promotion of effective legislative and regulatory regimes.
- Develop good governance standards and practices that apply to public companies.

As discussed further below, IFSA and ACSI have both sought to promote good corporate governance by developing best practice guidance for institutional investors and listed companies. IFSA, for example, issued its influential Blue Book on Corporate Governance in 1995, which enumerated the expectations about shareholder responsibilities for IFSA members and corporate governance practices for listed companies. Since its inception, the Blue Book has been amended six times, most recently in June 2009.

2.2. Legal rules and other guidance relating to shareholder rights and responsibilities

2.2.1. Shareholder rights

The analytical basis for this discussion is Principle II.C.3, which declares that "effective shareholder participation in key corporate governance decisions, such as the nomination and election of board members, should be facilitated. Shareholders should be able to make their views known on the remuneration policy for board members and key executives. The equity component of compensation schemes for board members and employees should be subject to shareholder approval."

Shareholders in Australia possess strong rights. The Corporations Act grants shareholders the right to amend a company's articles of association, appoint and remove a director, convene a shareholder meeting, and inspect the company's books. With respect to board appointments, director candidates are elected on individual ballots[7] and each director candidate must garner a simple majority of votes cast to be elected to the board. Correspondingly, shareholders are able to remove a director at any time[8] through a resolution at a shareholder meeting, which must be convened if requested by 100 shareholders or investors holding voting rights of 5% or more. Moreover, Section 203E of the Corporations Act explicitly prohibits the board from removing an incumbent director.[9]

Shareholder rights also extend to significant areas of executive and board remuneration. Australian Stock Exchange Listing Rules require companies to obtain prior approval from shareholders in order to issue any equity securities under an employee incentive scheme or raise the pre-existing maximum aggregate fees payable to directors. Since 2004, shareholders have had the right to express their views on executive compensation through a non-binding vote on the remuneration report. Similar to other jurisdictions, the Australian government introduced a non-binding "say on pay" in response to widely-held perceptions that the remuneration of top corporate executives was too high.[10]

In addition to "say on pay," several new shareholders rights have been promulgated in recent years. In 2000, shareholders were granted a statutory right to file "derivative" lawsuits, subject to court approval. Two years ago, companies were required to obtain shareholder approval for any termination payments to executives in excess of one year's salary.

The Australian government has now adopted a "two strikes" proposal whereby "no" votes on the remuneration report exceeding 25% for two consecutive years would trigger a resolution to require all directors to stand for re-election. If a majority of shareholders support such a resolution,[11] the entire board must be put up for re-election within 90 days of the vote.

While many shareholders in Australia support having a greater influence on executive remuneration, companies worry that the focus on compensation has become excessive. According to one company representative, "the board's contributions on strategy, investments, and divestments are much more consequential to company performance than its role in setting executive pay, yet the whole board may be removed under the 'two strikes' proposal simply because shareholders think they have paid the executives too much. This remedy is a bridge too far and clearly disproportionate".

2.2.2. Fiduciary duties and shareholder responsibilities

Similar to markets such as the UK and US, the fiduciary duty of investment managers in Australia is to act in the best interests of their clients. In particular, fund managers have a responsibility to their clients to manage their investments in accordance with the stated investment objectives. According to an ACSI representative, the fiduciary duty of superannuation fund trustees and agents under the Superannuation Industry (Supervision) Act 1993 is to act in the "best financial interests of all members by maximising returns and mitigating risks". With respect to the voting of shares held on behalf of clients, one investment firm executive declared that the firm's duty was "to vote if clients wanted them to do so and to vote in the best interest of clients".

In Australia, the concept of fiduciary duty has been established by a large body of case law and legal regulations. However, there is no overarching regime that sets out the duties and responsibilities of institutions. Instead, their duties and responsibilities are defined by the type of entity,[12] the services it is performing, and for whom those services are being performed. Similar to many OECD member countries, guidance on institutional shareholder responsibilities in Australia has emerged principally from industry best practice recommendations.

The IFSA Blue Book on Corporate Governance acknowledges that "as major shareholders, IFSA members are in a position to promote improved company performance that provides positive benefits to all shareholders and the economy as a whole" and further states that "effective corporate governance depends heavily on the willingness of the owners of a company to exercise their rights of ownership, to express their views to boards of directors and to exercise their voting rights". Similarly, ACSI recognises "the leading role that active institutional shareholders perform in each jurisdiction in lifting the standards of corporate governance".

Specifically, both organisations call on superannuation funds and investment managers to put in place policies relating to environmental, social, and governance (ESG) matters, vote their Australian equity holdings,[13] engage with investee companies, and consider material ESG issues in investment, voting, and engagement activities (see Tables 2.3. – 2.5.).

Table 2.3. **IFSA Blue Book – Summary of guidelines for fund managers**

Guideline 1 – Corporate Governance Policy and Procedures	Fund Managers should have a written Corporate Governance policy which is made available on their website. The policy should be approved by the board of the Fund Manager and should note the general principles underpinning formal internal procedures to ensure that the policy is applied consistently.
Guideline 2 – Communication with Companies	Fund Managers should establish direct contact with companies in accordance with their Corporate Governance Policy. Engagement with companies should include constructive communication with both senior management and board members about performance, Corporate Governance and other matters affecting shareholders' interests.
Guideline 3 – Voting on Company Resolutions	Fund Managers should vote on all Australian company resolutions where they have the voting authority and responsibility to do so. An aggregate summary of a Fund Manager's Australian proxy voting record must be published at least annually and within 2 months of the end of the financial year.
Guideline 4 – Reporting to Clients	Wherever a client delegates responsibility for exercising proxy votes, the Fund Manager should report in a manner required by the client. Reporting on voting and, where required, other corporate governance activities, should be a part of the regular reporting process to each client. The report should include a positive statement that the Fund Manager has complied with its obligation to exercise voting rights in the client's interest only. If a Fund Manager is unable to make the statement without qualification, the report should include an explanation.
Guideline 5 – Environmental and Social Issues and Corporate Governance	Fund Managers should engage companies on significant environmental and social issues that have the potential to impact on current or future company reputation and performance.

Source: Investment and Financial Services Association (2009), Blue Book on Corporate Governance, *www.ifsa.com.au*.

Table 2.4. **ACSI guide for superannuation trustees on the consideration of ESG risks in listed companies**

ACSI believes that there are six principal steps that superannuation investors can take to integrate ESG issues into the management of investment portfolios:	Put in place the right policies and frameworks on ESG issues.
	Ensure that their service providers (particularly asset consultants and investment managers) deal with ESG issues in a satisfactory way.
	Manage direct investments and investment portfolios with ESG issues in mind.
	Be "active owners".
	Where appropriate and relevant, seek to influence public policy.
	Ensure the fund's own ESG issues are in order.

Source: Australian Council of Superannuation Investors (2009), A guide for superannuation trustees on the consideration of environmental, social & corporate governance risks in listed companies, *www.acsi.org.au/acsi-guidelines.html*.

Table 2.5. **ACSI guide for fund managers and consultants on the consideration of ESG risks in listed companies**

ACSI members believe that fund managers (including those using passive investment styles) should:	Provide details of their ESG policies to trustees.
	Report to their clients about: • their expertise and resources to analyse ESG issues • their ESG activities, including research, voting and engagement with companies, and • how they integrate consideration of ESG issues into their investment analysis and decision-making processes
	Make considered use of their votes at company meetings, including voting in accordance with the ACSI member's instructions, where appropriate.
	Have a process to engage (either directly, indirectly or through outsourcing) with investee companies about their performance, ESG issues and other matters affecting shareholders' interests. However, we note that superannuation funds reserve the right also to engage with companies (either directly or through an intermediary) if they deem this to be appropriate in a particular case.

Source: Australian Council of Superannuation Investors (2009), A guide for fund managers and consultants on the consideration of environmental, social & corporate governance risks in listed companies, *www.acsi.org.au/acsi-guidelines.html*.

Given that most pension funds in Australia outsource some or all investment management to external asset managers, the IFSA standard-form investment management agreement also includes a default provision whereby the asset owner delegates voting to the investment manager.[14]

Whereas the IFSA Blue Book focuses on domestic activities, ACSI has developed guidance on institutional responsibilities with respect to both domestic and overseas equity holdings. The emphasis on international activities comes at a time when superannuation funds' overseas equity investments are expected to surpass their domestic holdings over the next few years.

As the 2008-2009 global financial crisis did not impact Australia significantly, there has been limited demand by policymakers or the public to strengthen the obligations of institutional investors by, for example, adopting an equivalent of the UK Stewardship Code. However, some companies favour strengthening institutional investor responsibilities in order to create a better balance between the extensive governance obligations of listed companies and the much less demanding responsibilities of institutional investors.

2.2.3. Disclosure obligations

There are no legal requirements in Australia relating to the disclosure by institutional investors of their corporate governance activities. However, through industry best practice guidelines, Australian institutional investors partially conform to the requirements of **Principle II.F.1**, which states that:

> "institutional investors acting in a fiduciary capacity should disclose their overall corporate governance and voting policies with respect to their investments, including the procedures that they have in place for deciding on the use of their voting rights."

The IFSA Blue Book recommends that a fund manager publish its voting record annually and within two months of the end of its financial year. In terms of content, IFSA Blue Book Guideline 4 calls on fund managers to report voting "in a manner required by the client" and provide "a positive statement that the Fund Manager has complied with its obligation to exercise voting rights in the client's interest only". Furthermore, the IFSA standard form investment management agreement obligates fund managers to furnish a copy of their proxy voting policies to their clients and inform them of any changes thereto.

Meanwhile, ACSI has adopted a softer tone, suggesting that a superannuation fund "may wish to consider publicly reporting on its ESG policies and its ESG activities (including voting and company engagement)". In practice, some superannuation funds voluntarily disclose their corporate governance policies and voting records on their websites.

In addition, there is no legal obligation to disclose conflicts of interest as recommended by **Principle II.F.2**, which states that:

> "institutional investors acting in a fiduciary capacity should disclose how they manage material conflicts of interest that may affect the exercise of key ownership rights regarding their investments."

An indirect reference to conflicts of interest is made in IFSA Blue Book Guideline 8.1.5, which states that if a fund manager is unable to make an unqualified statement that it "has complied with its obligation to exercise voting rights in the client's interest only", it should explain why.

More broadly, Paragraph 2.3 of *IFSA Code of Ethics and Conduct*[15] requires IFSA members to be fair and not allow conflicts of interest or bias to influence their actions. Paragraph 3.5 further states that where a conflict of interest arises, an IFSA member should conduct itself with the highest degree of integrity and fair dealing to ensure that customer interests are paramount in all decisions and transactions and to ensure that the conduct of the IFSA member contributes to an effective, efficient, and informed market. Similarly, institutional investors holding an Australian Financial Services Licence or regulated by the Australian Prudential Regulation Authority have obligations to properly manage conflicts of interest.

According to an Australian investment executive, conflicts of interest with respect to corporate clients is less acute in Australia than in other markets (such as the UK and US) due to the dwindling number of corporate superannuation funds in the country. At a large Australian investment firm, for example, only 5 out of 30-plus superannuation clients are corporate pension funds.

2.3. Exercise of shareholder rights

2.3.1. Overview

There is some evidence that institutional investors in Australia are striving to meet the expectations of Principle II.F.1, the annotation of which stresses that:

> "the effectiveness and credibility of the entire corporate governance system and company oversight will ... to a large extent depend on institutional investors that can make informed use of their shareholder rights and effectively exercise their ownership functions in companies in which they invest."

As summed up by a prominent Australian commentator, "there is more push back from institutional investors when things go wrong at companies today".

In Australia, superannuation funds and investment managers have become more diligent in exercising ownership rights over the past decade, prompted by a perception of passivity during the corporate collapses of the 1980s and 1990s, a rise in the holdings of institutional investors, and strengthened shareholder rights. Greater institutional investor involvement on corporate governance has been spearheaded by superannuation funds, particularly industry funds with their labour union heritage. A small number of fund managers – including large institutions such as AMP and Colonial First State and smaller outfits such as Perpetual Investments – have also gained a reputation as interested share owners. In addition, listed unit trust AFIC, a top 20 shareholder in many Australian companies, and the Future Fund, established by federal legislation in 2006 to help meet unfunded superannuation liabilities of government employees, are known to take corporate governance seriously.[16]

Although foreign investors own 42% of the equity in Australian listed companies (Stapledon, 2011), they have not been actively involved – in terms of voting and engaging on corporate governance matters – in the Australian market. Many foreign investors do not vote their Australian shares and those that do typically follow the recommendations of proxy voting agencies.

A decade ago, there were no expectations on investment managers to focus on corporate governance. Since then, however, superannuation funds have increasingly pressed their asset managers to vote and engage investee companies more actively. Importantly, some superannuation funds, such as HESTA and Cbus, take a fund manager's corporate governance record into account when awarding investment mandates. One superannuation fund stated that it was willing to pay a higher management fee to enable fund managers to devote greater resources to corporate governance activities.

At the same time, however, many superannuation funds appear to incentivize their asset managers to deliver short-term performance. According to a veteran investor relations executive, fund managers in Australia rarely ask questions on long-term sustainability and corporate governance matters because their superannuation clients focus mostly on their near-term performance.

More recently, the United Nations Principles for Responsible Investment (UNPRI) – which strive to encourage institutional investors to incorporate ESG considerations into investment decision-making and behave as active owners – have also helped to increase the ESG activities of Australian institutional investors. As of January 2011, Australian

institutions accounted for 14% of UNPRI signatories worldwide (121 out of 872). According to one asset manager, superannuation funds that have signed up to the UNPRI have "harassed their asset managers" to do more on corporate governance so that they can declare that they are complying with UNPRI requirements.

To a certain extent, the relatively small size of the Australian market has facilitated monitoring of investment managers by their superannuation clients. For example, some pension funds – particularly the larger ones – would occasionally telephone their asset managers to inquire about corporate governance matters. At one public superannuation fund, the investment team monitors external asset managers by selecting a handful of controversial shareholder meetings to audit each quarter. Yet, some commentators have observed that most superannuation funds do not pay much attention to the voting records disclosed by their asset managers.

2.3.2. Role of proxy advisors

As further discussed below, the exercise of voting rights by institutional investors in Australia is facilitated to a great extent by proxy research providers. In fact, IFSA helped to establish Corporate Governance International (known today as CGI Glass Lewis) in the mid-1990s specifically to advise fund managers on voting matters.

CGI Glass Lewis and Institutional Shareholder Services (ISS) are the two main proxy research providers in Australia and both wield substantial influence. While Glass Lewis and ISS are headquartered in the US, their presence in Australia was established through acquisitions of local outfits.[17] Consequently, in contrast to many countries, CGI Glass Lewis and ISS are generally regarded as domestic institutions.

According to a superannuation fund executive, conflicts of interest among proxy research providers are not a problem in Australia. For example, ISS Australia differs from its counterparts in the United States and Europe in that it does not offer any consulting services to corporate issuers. While CGI Glass Lewis charges companies a fee to receive its proxy research, this arrangement is widely known and not perceived to constitute a serious conflict of interest. It is worth noting that because proxy research providers furnish facts and opinions that their clients are free to follow or ignore and are not granted decision-making authority with respect to voting the holdings of their clients, they do not owe their clients fiduciary obligations to which investment managers are subject.

With a competitive market for proxy research, coverage of a substantial proportion of listed Australian companies, and limited conflicts of interest amongst proxy voting firms, Australia largely conforms – with respect to voting-related analyses – to Principle V.F, which states that:

> "the corporate governance framework should be complemented by an effective approach that addresses and promotes the provision of analysis or advice by analysts, brokers, rating agencies and others, that is relevant to decisions by investors, free from material conflicts of interest that might compromise the integrity of their analysis or advice."

2.3.3. Voting and engagement practices

Voting turnout at shareholder meetings in Australia has risen steadily over the past decade, from around 35% at the end of the 1990s to approximately 60% today. A key

development that magnified the attention paid to voting was a 2000 study showing that only 35% of outstanding shares were voted at Australian companies in 1999, compared to 50% in the UK, 73% in Germany, and 80% in the US over the same period. Prompted in part by the collapse of a major insurance company (HIH), ACSI has played a prominent role in raising voting turnout by encouraging its superannuation fund members to vote, which in turn have exerted pressure on their asset managers to follow suit.

However, voting by retail shareholders continues to be at a low level. At an Australian bank whose investor base consists of approximately 55% domestic retail, 30% domestic institutional, and 15% foreign shareholders, only 40% of shares are typically voted, the bulk of which is believed to represent institutional holdings.

Most superannuation funds delegate voting to their investment managers. At a large investment firm, only 15% of its superannuation clients have decided to vote their own holdings. Super funds that choose not to delegate voting to their asset managers are typically the larger schemes, such as Australian Super, UniSuper, HEST and Cbus. Amongst these funds, only a few have dedicated internal resources to carry out voting, with the rest generally following the proxy voting advice of ACSI[18] or another provider.

At investment management firms, most rely on individual fund managers or analysts to carryout voting. Exceptionally, AMP, BlackRock, and a few others – mirroring the standard practice at large institutional investment firms in the UK and US – have dedicated corporate governance teams to undertake this activity. According to commentators, Australian fund managers have not adopted the proxy voting model of their UK-US counterparts because most Australian equity portfolios are of manageable size (up to 80 holdings). To some, voting by fund managers and analysts is ideal because these individuals are highly familiar with the companies they vote on.[19] Moreover, this approach helps to integrate voting and investment decision-making.

Some superannuation funds in Australia engage in share lending, usually through their custodians. However, it is uncertain the extent to which shares are recalled when contentious items appear on a shareholder meeting agenda.

Most investment firms subscribe to external proxy research to help them reach voting decisions. Despite greater expectations on institutional investors to vote their shares actively, many fund managers in Australia – particularly smaller outfits – continue to slavishly follow the recommendations of their proxy providers and some are loathe to express dissenting views. According to one observer, a large Australian asset manager "would bend over backward to avoid voting against any resolution".

The annotation of Principle II.F.1 notes that "a complementary approach to participation in shareholders' meetings is to establish a continuing dialogue with portfolio companies". In Australia, the IFSA Blue Book provides that, where a fund manager intends to vote against a resolution, he should engage with the company sufficiently in advance of the shareholder meeting with "a view to achieving a satisfactory solution".[20] In practice, this recommendation does not appear to be embraced fully. At the Australian subsidiary of a global investment firm, pre-shareholder meeting communication is undertaken only for holdings in excess of 5%. For all other holdings, a letter explaining the firm's voting decision is sent after the shareholder meeting.

Nonetheless, engagements between institutional investors and companies on corporate governance matters – in relation to voting resolutions at shareholder meetings and other contexts – have become more prevalent in recent years. On their part, companies

generally appear to be adopting a more proactive approach to engaging with their shareholders on corporate governance. Whereas meetings between the CEO/CFO and investors to discuss company performance are an established practice, discussions between chairmen and institutional investors on governance matters are a relatively recent phenomenon.

The advisory vote on the remuneration report has served as the impetus for increased shareholder-company engagement. According to ACSI, "the introduction of a non-binding shareholder vote has been the single biggest catalyst for improved levels of engagement". Proxy advisor CGI Glass Lewis similarly observed recently that there has been "a significant increase in dialogue instigated by (non-executive directors) on remuneration issues since the non-binding vote was introduced … Ten years ago engagement by listed entities with their key institutional shareholders was minimal."

At a large mining company, for instance, the chairman – accompanied by the company secretary or head of investor relations – arranges meetings once a year with the firm's largest institutional investors in Australia and abroad. In Australia, the chairman sees mostly investment firms, although he will also meet with superannuation funds that have "clawed back" voting from their investment managers. Topics addressed in recent years include executive compensation, environmental and social issues, board governance, and acquisitions. Correspondingly, the remuneration committee chair will meet with the firm's most significant investors to discuss compensation matters, particularly when changes are proposed. Over the past few years, the company has become more proactive in engaging its shareholders on corporate governance-related matters, particularly relating to executive pay.

Similarly, led by the chairman and remuneration committee chair, the board of a domestically-focused Australian bank has stepped up engagement with the institution's top investors. Given that the bank's shareholder base is primarily Australian, the board focuses on meeting domestic investors. In terms of timing, the chairman would initiate a dialogue with its largest half-dozen shareholders when the annual shareholder meeting notice is published – the principal purpose of these meetings is to give investors an opportunity to ask questions. Even though the bank has outperformed its peers and support for its remuneration report has exceeded 90% the past couple of years, the board is nonetheless paying close attention to investor perceptions of its remuneration arrangements due to the continuing public scrutiny on compensation in the financial sector.

In terms of overall market trends, executive remuneration appears to be receiving the most attention in engagements between investors and companies. However, other ESG-related issues – such as board independence, succession planning, and sustainability – are also routinely addressed.

One company representative observed that engagement approaches and quality differ markedly amongst institutional investors – some are extremely well-prepared while others are much less diligent. Broadly speaking, fund managers tend to focus on operational and financial issues while superannuation funds place a greater emphasis on corporate governance and sustainability matters.

The reliance of domestic and foreign institutional investors on proxy research providers in reaching voting decisions means that companies must also engage with these advisers on voting-related topics. The mining company mentioned above, for example,

typically meets with proxy research firms several times a year to discuss matters to be voted on at the shareholder meeting.

Due to a dearth of internal resources as well as a belief that collective engagements are more effective than one-on-one meetings, many superannuation funds rely on ACSI to engage on their behalf. Each year, ACSI agrees with its members the key engagement themes. In 2010, the priority issues were executive remuneration, board representation (particularly diversity), sustainability report, commitment to tackling climate change, and company performance. Thereafter, ACSI identifies approximately 60 Australian companies with which to engage on one or more of the priority themes. In terms of participation, ACSI members are normally invited to the company meetings that it organises. Several members, such as HESTA, attend regularly.

Some superannuation funds also delegate engagement to Regnan, a for-profit advisory firm owned by eight institutional investors. In 2009-2010, Regnan's engagements focused on board quality (board performance, board diversity, and mix of skills), executive remuneration, and ESG disclosure.

By contrast, there is no industry body to facilitate collective engagement amongst investment managers. Individual asset managers also do not engage as a group, although they may discuss corporate governance matters informally with each other. One investment manager mentioned that collective engagements do not take place amongst managers due in part to fears of violating "concert party" regulations.

The conflicting positions of superannuation funds and investment managers regarding collective engagement suggest that Australia may not be fully compliant with **Principle II.G.**, which stipulates that:

> "shareholders, including institutional shareholders, should be allowed to consult with each other on issues concerning their basic shareholder rights as defined in the Principles, subject to exceptions to prevent abuse"

and II.F.1, which states that institutional investors:

> "should be allowed, and even encouraged, to co-operate and co-ordinate their actions in nominating and electing board members, placing proposals on the agenda and holding discussions directly with a company in order to improve its corporate governance."

Some commentators – including ACSI and several legal academics – have argued that Class Order 00/455, the "safe harbour" promulgated by the Australian Securities and Investments Commission (ASIC), does not provide sufficient protection to shareholders engaging collectively on corporate governance matters.[21] Under this safe harbour, two or more institutions planning to act collectively will not breach Corporations Act shareholding notification and takeover provisions provided they comply with its requirements.

The criticism of Class Order 00/455 centres on two areas. First, the Class Order applies only to voting actions, whereas engagements between shareholders and companies often encompass non-voting matters. Second, the current safe harbour requires institutional investors to formally notify ASIC of their collective activities. Most engagements between

companies and their shareholders, however, are highly informal and undertaken in private.

On a separate but related matter, there are safeguards to ensure that shareholder-company engagements comport with Principle II.F.1 annotation that:

> "it is incumbent on the company to treat all investors equally and not to divulge information to the institutional investors which is not at the same time made available to the market."

The IFSA Blue Book, for instance, admonishes that "companies and fund managers should manage communications so that no investor or potential investor obtains material or price-sensitive information that has not been disclosed to the market in accordance with the Corporations Act and the ASX Listing Rules". The Blue Book also states that:

> "if a fund manager considers that material information has been provided during discussions with a company, it must warn the company that it may have breached the continuous disclosure provisions of the Corporations Act. The fund manager must implement appropriate mechanisms to ensure that the information is strictly safeguarded and insulated from any other activity. This may include a temporary ban on trading in the company's shares or implementing 'Chinese Walls' until the appropriate disclosures have been made to the full market."

From the perspective of companies, a key challenge is reconciling the diverse views of institutional investors on a broad array of topics, particularly executive remuneration. In addition, some company directors are concerned about the ideological stances of certain investor representatives. Lastly, there appears to be some confusion amongst company directors as to who – between superannuation funds and their asset managers – has responsibility for voting and engagement on corporate governance and sustainability matters.

2.3.4. Areas of contention between shareholders and companies

In recent years, shareholders and companies have clashed on a number of topics, including executive remuneration, board accountability, and buyout terms.

Since its introduction in 2004, the non-binding vote on executive remuneration has served as a key tool for institutional shareholders to voice their dissatisfaction. Amongst countries that have introduced "say on pay", investors in Australia have utilised it most aggressively, as indicated by the level of "no" votes on the remuneration report.

In 2009, 27 companies in Australia suffered votes against of greater than 25% on the remuneration report, including seven firms that garnered opposition of greater than 50% (Table 2.6). In 2010, "say on pay" resolutions at 8 Australian companies failed to win the support of a majority of investors. By way of comparison, less than ten companies in the UK have seen their remuneration reports defeated since the introduction of "say on pay" in 2003.

In addition, institutional investors have removed directors at several poorly performing companies in the past couple of years. In November 2010, institutional investors played an instrumental role in ousting two directors at Transpacific Industries. At

Table 2.6. **Substantial no votes in remuneration reports in 2009**

Company	"No" vote percentage (%)	Index
Abacus Property Group	31	ASX200
Aspen Group	48	ASX300
Avoca Resources	26	ASX200
Babcock and Brown Infrastructure	32	ASX200
Bendigo and Adelaide Bank	32	ASX100
Cabcharge	45	ASX200
Challenger Financial	29	ASX200
Clough	36	ASX300
Crane Group	43	ASX200
Dominion Mining	37	ASX200
Downer EDI	59	ASX100
Energy Developments	60	ASX300
Kingsgate	52	ASX200
Lend Lease	42	ASX100
Macmahon Holding	28	ASX200
Nexus Energy	27	ASX200
Novogen	81	ASX300
NRW Holdings	53	ASX300
Qantas	43	ASX50
Ramsay Health Care	32	ASX200
Riversdale Mining	25	ASX200
Sims Metal Management	29	ASX100
St Barbara	58	ASX200
Straits Resources	48	ASX200
Transurban	47	ASX50
United Group	49	ASX100
Western Areas	56	ASX200

Source: Australian Government Productivity Commission (2009), Executive Remuneration in Australia, *www.pc.gov.au/projects/inquiry/executive-remuneration*).

several companies, one or more board directors ultimately decided to not stand for re-election when they realised they did not have sufficient backing from shareholders.

Activism on voting has also extended to investment matters. One commentator noted that, a decade ago, most fund managers "wouldn't think of opposing mergers" but an increasing number of them are now willing to spurn offers that they perceive as undervaluing the target company. In 2007, a private equity consortium made an offer to buy Qantas airlines. Even though Qantas's board had recommended acceptance of the offer and the Australian government had approved the transaction, a majority of shareholders – led by institutional investors – declined to tender their shares because they felt the offer price was too low. The consortium's bid ultimately failed.

The News Corporation litigation is perhaps the most emblematic example of increased institutional investor activism in Australia. In 2004, media conglomerate News Corporation announced its intention, subject to shareholder approval, to change domicile from Australia to the US state of Delaware. To protect against a weakening of shareholder rights arising from this move,[22] a group of Australian and international institutional investors (led by ACSI) reached agreement with the company to preserve certain shareholder rights – including a requirement to obtain shareholder consent if the company decides to extend its poison pill in excess of one year – in return for their support.

In August 2005, News Corporation announced a two-year extension of its poison pill without first obtaining shareholder approval. After attempts to convince News Corporation to honour their previous commitment proved futile, twelve Australian and international pension funds sued the company in Delaware to enforce the 2004 agreement. In April 2006, two weeks prior to the scheduled start of trial, News Corporation acceded to the demands of the institutional shareholders.

2.3.5. *Impediments*

Although shareholders in Australia possess strong rights, there are some impediments to the effective exercise of those rights. First, as discussed above, the ASIC safe harbour on collective activities appears to provide inadequate protection to institutional investors. Second, similar to other jurisdictions where the processing of votes remains largely manual, uncounted votes are an issue. For instance, a 2006 study by investment manager AMP revealed that 4% of its voting instructions had been "lost".

Third, the ability of Australian companies under the ASX Listing Rules to issue up to 15% of shares annually without pre-emptive rights[23] has been mentioned by commentators as constraining investor activism because institutional shareholders fear they would not be allocated their proportionate shares in future capital-raising transactions. In other words, institutional investors are concerned about being diluted if they speak out aggressively against companies.

In addition, some commentators assert that investment managers have not exhibited a strong interest in corporate governance because they are incentivized by their clients (including superannuation funds) to deliver short-term performance.

2.4. Conclusions

Overall, institutional investors in Australia appear to be taking their ownership responsibilities more seriously, including greater diligence and activism in exercising shareholder rights. However, commentators have noted that a number of institutional investors continue to be rather passive, as evidenced by their heavy reliance on proxy research providers for voting and industry bodies for engagement and, with respect to superannuation funds, the dearth of internal resources to undertake monitoring of the corporate governance activities of their investment managers. Consequently, current institutional investor practices in Australia on voting and engagement may not fully meet Principle II.F.1 expectation that institutional investors "set aside the appropriate human and financial resources to pursue this [corporate governance] policy in a way that their beneficiaries and portfolio companies can expect".

Looking forward, there is an expectation that the focus of engagement between companies and shareholders will expand to a broader array of ESG issues. Due in part to the extreme weather patterns that Australia has experienced recently and its proximity to Southeast Asia, where environmental topics such as rain forest preservation have come to the fore, there is growing recognition by shareholders and companies that they must jointly address environmental risks.

In addition, one commentator predicts that as superannuation funds continue to grow and their holdings in individual firms rise, they may become more active in director appointments, including by directly nominating candidates to sit on the boards of investee companies.

Annex 2.1. Summary of legal provisions relating to the fiduciary responsibilities of institutional investors in Australia

Responsible entity

Under paragraph 601FC(1) of the Corporations Act, the fiduciary duties of a responsible entity are:

a) the duty to act honestly;

b) the duty to act in the best interests of members and, if there is a conflict between the members' interests and its own interests, give priority to the members' interests;

c) the duty to treat members who hold interests in the same class equally and members who hold interests in different classes fairly;

d) the duty to not make use of information acquired through being the responsible entity in order to gain an improper advantage for itself or another person or cause detriment to members of the scheme; and

e) the duty to ensure that scheme property is *i)* clearly identified as scheme property and *ii)* held separately from the property of the responsible entity and the property of any other scheme.

Superannuation trustees

Under section 52(2) of the Superannuation Industry (Supervision) Act 1993, the duties of a superannuation scheme trustee include:

a) the duty of efficient management (that is, to preserve the trust property);

b) the duty of loyalty;

c) the duty to keep and render to the beneficiaries full and candid accounts;

d) the duty to act personally;

e) the duty to consider from time to time whether to exercise powers; and

f) the duty to exercise powers for proper purposes and upon relevant considerations.[24]

Australian Financial Services Licence holders

Under section 912A of the Corporations Act, the responsible entity or trustee, as an AFSL holder, is required to comply with (amongst other things) the obligation to:

a) do all things necessary to ensure that the financial services covered by the licence are provided efficiently, honestly and fairly;

b) have in place adequate arrangements for the management of conflicts of interest;

c) for a responsible entity, have available adequate resources (including financial, technological, and human resources) to provide the financial services covered by the licence; and

d) have adequate risk management systems.

Notes

1. In 2009, domestic institutional investors owned approximately 36% of the shares in quoted Australian companies while foreign shareholders held approximately 42%. As two-thirds of foreign shareholders are estimated to be institutional investors, the holdings of domestic and international institutional investors in listed Australian equities totalled approximately 64% (Stapledon, 2011).

2. Although IFSA was recently renamed the Financial Services Council, the latter name is not yet widely used.
3. The superannuation guarantee charge was originally set at 3% and increased gradually until it reached 9% in 2002. In 2010-2011, the annual earnings limit on which the SGC is calculated is AUD 168 880.
4. Under the government's proposal, the SGC is to be increased in two stages – rising in annual increment of 0.25% during 2013-2014 and 0.50% thereafter until 12% is reached.
5. According to the Australian Prudential Regulatory Authority, "balance of life office statutory funds" are assets held for superannuation or retirement purposes in statutory funds of life insurance companies.
6. According to commentators, the majority of Australian workers pick the default fund designated by their employers because they are not familiar with the alternative choices available to them.
7. By contrast, directors standing for re-election are often bundled as a group as in such countries as Canada and Germany.
8. Section 201D(1) of the Corporations Act provides that "a public company may by resolution remove a director from office despite anything in: *a)* the company's constitution (if any); or *b)* an agreement between the company and the director; or *c)* an agreement between any or all members of the company and the director".
9. Of course, the board can choose not to re-nominate a director upon the expiration of his/her current term.
10. For example, a 2001 survey by investment consultants Towers Perrin showed that Australian CEOs were the third highest paid among the surveyed markets, after the US and UK.
11. This resolution is to be voted on at the shareholder meeting where the company's remuneration report received "no" votes in excess of 25% for the second consecutive year. However, detailed voting mechanics have not been developed (*i.e.* would shareholders vote on this resolution at the same time as they vote on the other resolutions appearing on the shareholder meeting agenda or would they be asked to vote on this resolution only after the voting results on the remuneration report are known?).
12. The responsibilities of the "responsible entity" (manager) of a unit trust are defined under Chapter 5C of the Corporations Act, general law, and the specific scheme constitution. Correspondingly, the responsibilities of superannuation trustees are set out in Section 52 of the Superannuation Industry (Supervision) Act 1993. Responsible entities and superannuation trustees that hold Australian Financial Services Licences must also adhere to obligations under Section 912A of the Corporations Act. See Appendix A for a summary of these provisions.
13. In contrast to the United States, where corporate pension funds are required to vote their shares, neither superannuation funds nor investment managers in Australia are obligated to exercise their voting rights. However, some Australian legal scholars have argued fiduciaries must ensure that "active and genuine consideration has been given to the issue of whether to vote" (Ali, Gold, and Stapledon, 2003).
14. Section 12.1 provides that "the Trustee authorises the Manager to exercise any right to vote attached to a share or unit forming part of the Portfolio or to so direct the Custodian. In the event that the Manager receives a direction from the Trustee in relation to the appointment of a proxy and the way in which the proxy should vote, the Manager must use its best endeavours to implement the direction, but in the absence of any direction, the Manager may exercise or not exercise the right to vote as it sees fit, having regard to any general direction."
15. IFSA Standard No. 1: Code of Ethics and Conduct (available at *www.ifsa.com.au*).
16. The Future Fund was funded by the Australian government through infusions of AUD 51.3 billion in cash and AUD 9.2 billion in Telstra shares. The fund held assets of AUD 67 billion as of June 2010.
17. ISS purchased Proxy Australia in 2005 while Glass Lewis bought Corporate Governance International in 2006.
18. In terms of mechanics, ACSI has contracted with proxy research giant Institutional Shareholder Services to generate voting recommendations for Australian shareholder meetings based on ACSI's corporate governance policies. In terms of policy, ACSI and ISS follow similar approaches, although ACSI is stricter on director independence and executive remuneration – consequently, ACSI's voting recommendations tend to contain a higher proportion of "votes against" on these two issues. ACSI has entered into a similar arrangement with CGI Glass Lewis with respect to

voting recommendations for overseas shares but only a few ACSI members currently subscribe to this service.

19. By contrast, in many countries, corporate governance specialists have been criticised for failing to consider (and understand) a company's individual circumstances when rendering their voting decisions.

20. This is similar to the practice in the UK.

21. For further details, see McKay R. (2007) Collective Action by Institutional Investors is More Than a Passing Fad, Australian Council of Superannuation Investors (available at *www.acsi.org.au/general/collective-action-by-institutional-investors-is-more-than-a-passing-fad.html*).

22. In general, Delaware provides less extensive shareholder rights than Australia and News Corporation admitted that the company law framework in Delaware was less "shareholder friendly."

23. By way of comparison, the UK Pre-emption Guidelines permits disallowing pre-emption rights up to a limit of 5% a year and 7% over a rolling 3-year period.

24. Extracted from Ali, P., M. Gold and G. Stapledon (2003).

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PART II

Chapter 3

Chile: The Role of Institutional Investors in Promoting Good Corporate Governance

This chapter explores the experience of Chilean institutional investors in promoting good corporate governance practices in the companies in which they invest. It documents the influence of institutional investors, particularly the Pension Fund Administrators (AFPs under their Spanish acronym), which is one of the key factors explaining the current corporate governance landscape and the development of its capital market. This report describes the rules, practices and prominent cases that have contributed to shape Chile's institutional investors behaviour.

The influence of institutional investors, particularly the Pension Fund Administrators (AFPs under their Spanish acronym), is perhaps one of the key factors explaining the current corporate governance landscape and the development of the capital market in Chile. The large pool of assets under their administration as well as their active engagement in improving and promoting good corporate governance practices in the companies where they invest, have turned institutional investors into influential actors. They have become strong enough to stand up to powerful controlling shareholders in the concentrated Chilean stock market. As *Strengthening Latin American Corporate Governance: The Role of Institutional Investors* (OECD, 2011b) pointed out, in Chile as in many other Latin American countries, the institutional investors are playing a primary role in the stock market growth, as the largest and most influential minority shareholder for many listed companies.

Compared to AFPs, other Chilean institutional investors such as mutual funds, insurance companies, and investment funds have not assumed a similar role in relation to corporate governance practices. As stated by the OECD Report on Corporate Governance in Chile (OECD, 2011a),

> "government requirements for investment and insurance funds have been a lower public policy priority so far in Chile due to their smaller size and impact on the equity markets, and the perspective that pension funds have a higher regulatory threshold to meet not only because of their greater impact on the market, but also due to their mandatory nature and role in providing for all Chileans' retirement."

The Chilean stock market where these investors interact is characterized by a relatively small number of firms with a significant degree of ownership concentration, and where financial conglomerates control the boards of most listed companies. As Lefort and Walker (2000) showed, pyramid schemes are the most common way of achieving control in Chilean conglomerates, since cross-holdings are forbidden by law and dual (or multiple) class shares are unusual. Pension funds are the main minority shareholders of Chilean companies, investing a significant proportion of their resources in the domestic corporate sector. In fact, according to Agosín and Pastén (2003):

> "a specific feature of Chilean capital markets is the existence of well-developed institutional investors, specifically the private pension funds that arose from the pension reform of 1981 where in spite of the limitations imposed upon the AFPs in the kinds of investments they can make, they have been responsible for a significant deepening of the stock market".

The influence of institutional investors in the Chilean corporate governance framework has been well documented. Iglesias (2000) argues that pension fund participation in the stock market has had positive effects on: *i)* the number of independent board members; *ii)* a decrease of monitoring costs as a result of improved quality of public

information; *iii)* an enhancement of the supervision of companies where pension funds have invested; and *iv)* an improvement of bondholder's protection.

More recently, Lefort (2007), analyzing the direct and indirect channels through which the AFPs may influence Chilean companies, concludes that such influence is particularly positive in three areas: *i)* the emergence of legal reforms and the improvement of oversight under which the companies operate, affecting the quality of the regulatory external mechanisms of corporate governance; *ii)* the development of greater liquidity in capital markets by the growth of funding and the volume of their trading; and *iii)* the professionalization of the financial intermediaries and the adoption of more advanced and cost-efficient transaction processes. He also concludes that the direct monitoring and intervention of AFPs in exercising their rights as minority shareholders, or as bondholders, has contributed to improving the internal mechanisms of corporate governance of Chilean companies.

Furthermore, Lefort and Walker (2007) point out that after controlling for ownership and control structure, companies with institutional investors as shareholders show a statistically significant increase in market value. By the same token, Lefort and Urzúa (2007) show that having institutional investors as shareholders is correlated with a greater number of independent directors in boards, and that there is a premium for companies with such directors.

Considering these features, Chile was an obvious candidate for a review of the role of institutional investors as shareholders. Prima facie, it seemed clear that the case for lack of engagement and passivity of institutional shareholders should not be applicable to Chile. This report describes the extent to which that is true, as well as the rules, practices and prominent cases that contributed to and explain this phenomenon.

This report is organized in four sections. Section 1 describes the main aspects of the Chilean corporate governance landscape, describing its stock market and addressing ownership and control, as well as the relative importance of institutional investors in the market, particularly pension funds. Section 2 deals with the legal and regulatory framework affecting institutional investors and their supervision. Section 3 reviews evidence of the role of AFPs in improving corporate governance practices in Chile. The last section offers some conclusions.

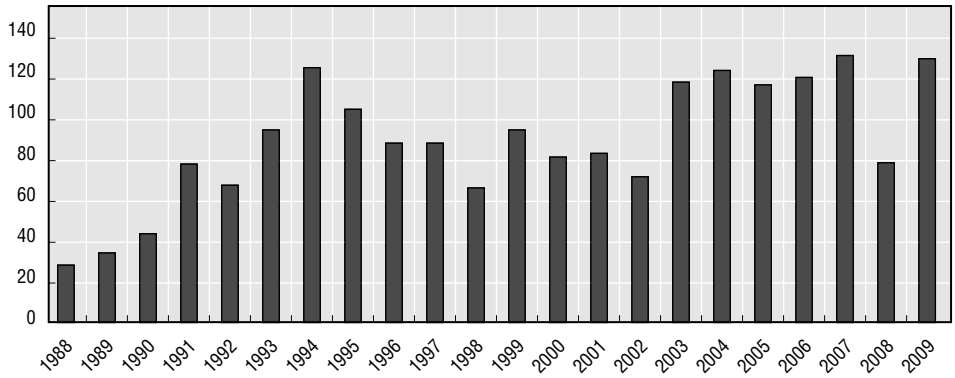
3.1. The corporate governance landscape

3.1.1. The Chilean stock market[1]

The Santiago Stock Exchange (SSE) constitutes the third largest equity market in Latin America, behind the stock exchanges of Brazil and Mexico, with a relatively high market capitalisation of USD 230 billion for 230 listed firms at the end of 2009 – equivalent to 127% of GDP (Figure 3.1).

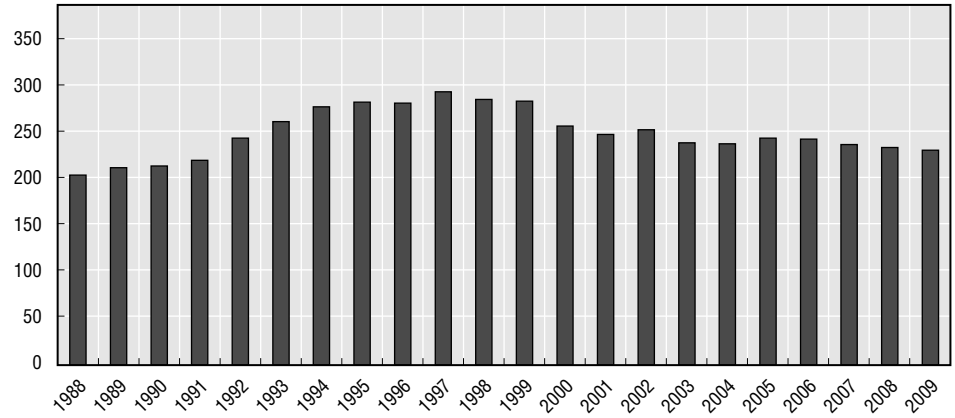
The SSE is the largest of the three stock exchanges, responsible for approximately 86% of transactions, while the Electronic Stock Exchange accounts for 13%, and the Valparaíso Stock Exchange has less than 1% (Larrain, G. *et al.*, 2008). As of September 2007, the free float (defined as shares not owned by controlling parties) was estimated at 36% of equity in the IPSA and IGPA indexes. The IPSA index is made up of the 40 most traded firms with greater than USD 200 million in market capitalisation, reflecting 74% of overall market capitalisation, while the IGPA index tracks the 138 most significant and actively traded stocks among the 230 companies listed on the market (Figure 3.2).

Figure 3.1. **Chilean listed market capitalisation to GDP (%)**



Source: World Bank Data (n.d.), "Market capitalization of listed companies (% of GDP)", *http://data.worldbank.org/indicator/CM.MKT.LCAP.GD.ZS/countries/CL?display=graph*, accessed February 2011.

Figure 3.2. **Number of Chilean listed companies**



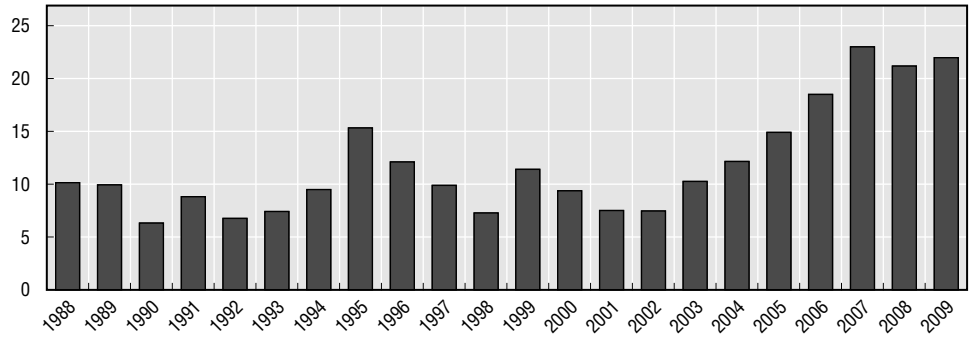
Source: World Bank Data (n.d.), "Listed domestic companies", *http://data.worldbank.org/indicator/CM.MKT.LDOM.NO/countries/CL?display=graph*, accessed February 2011.

With an average volume of USD 196 million in 2007, Chile's daily trading is relatively low, at less than 10% of total market capitalisation, and new listings are rare. However, the number of listed companies can be considered as relatively high in relation to population, constituting about 15 firms per million inhabitants, according to the Chilean Ministry of Finance. Most of Chile's largest firms are listed in the local markets, with the proportion of equity of Chilean firms cross-listed on US exchanges falling in the range of 8-10% of Chile's market capitalization since 2003. Chile's listed firms are also relatively diversified. Chile's IGPA index, which tracks the most significant and actively traded listed firms, comprises 28% of firms from the utilities sector, 20% from commodities, 20% industrial, 9% financial, 9% retail, 7% in consumer goods, and 6% in communications and technology.

The lack of liquidity of the Chilean stock market is further exacerbated by the fact that domestic pension funds hold about one-fourth of the free float, and tend to hold onto their shares. By comparison, 12 Chilean corporations listed abroad through ADRs account for another USD 50 million in daily trading, approximately 25% of the Santiago Stock Exchange's daily turnover (Lefort and Walker, 2007).

While overall liquidity is low, it has been improving, with annual trading volume rising from about 10% of GDP in 2002 to about 30% by 2007. Turnover – defined as total annual

Figure 3.3. **Turnover on Chilean listed market (%)**



Source: World Bank Data (n.d.), "Stocks traded, turnover ration %", *http://data.worldbank.org/indicator/CM.MKT.TRNR/countries/CL?display=graph*, accessed February 2011.

trading volume divided by market capitalisation – has increased from 7% to 22% during the 2002-09 period (Figure 3.3).

3.1.2. The corporate governance framework

Chile's current corporate governance landscape reflects historical influences over the last four decades. Chile's economy featured heavy state control and nationalisation of the copper sector and other important industries under the Allende government, which culminated with a severe economic crisis before the military coup in 1973. A period of market-oriented reforms and massive privatisations followed. By 1990, about 550 enterprises under public-sector control, including most of Chile's largest corporations, had been privatised. By the end of 1991, fewer than 50 firms remained in the public sector. The overall privatisation programme undertaken in the late 1980s has been criticised by some Chilean and international economists who have suggested that banks and manufacturing firms were sold too rapidly and at "very low prices" (Lüders, 1991), contributing to the current landscape of concentrated ownership and conglomerate dominance. Reform of the banking sector, following a banking crisis in the early 80s, and privatisation of the Chilean pension system also took place during this period.

The Corporations Law and the Securities Market Law, both enacted in 1981 and amended several times since, are the principal pieces of legislation bearing on corporate governance in Chile. Key amendments have included laws enacted in 2000 on Public Tender Offers and on Corporate Governance, which moved to strengthen minority shareholder rights by, among other things, enhancing disclosure and establishing directors' committees which serve a role similar to audit committees.

Chile has recently taken major steps to improve its corporate governance legal framework. The 2009 Corporate Governance law strengthens protection for minority shareholders through enhanced transparency standards and mechanisms for addressing use of privileged information, related party transactions and the management of conflicts of interest. Other provisions improve the definition of independent directors and strengthen their role in reviewing sensitive issues relevant to minority shareholder protection through the directors' committees.

Chile's Superintendence of Securities and Insurance (SVS) is responsible for overseeing the securities and insurance markets, while separate regulators oversee pension funds (Superintendence of Pension – SP) and banks.

3.1.3. Ownership and control

One of the main features of Chile's corporate sector is the very high concentration of ownership of individual firms, usually in the hands of conglomerates or business groups that are also few in number. These business groups function as holdings, having majority stakes in a large number of firms, and minority stakes in others. They seek control basically through pyramidal structures with several layers of investment companies above the level of operating firms (Table 3.1).

Table 3.1. **Ownership concentration (average per year)**

Percentage

Year	Rights of the controlling shareholder	
	Control	Cash flow
1990	63	56
1995	65	57
2000	70	61
2005	70	61
2009	68	59

Source: Larrain, B., M. Donelli, and F. Urzúa (2010), "Ownership dynamics with large shareholders: An empirical Analysis", available at *www.faceapuc.cl/personal/blarrain/papers/ownerdynamics.pdf*.

As of 2002, some 50 major conglomerates had ownership control of more than 70% of non-financial listed companies, and companies controlled by them accounted for more than 90% of total equity in the SSE (Lefort and Walker, 2007).

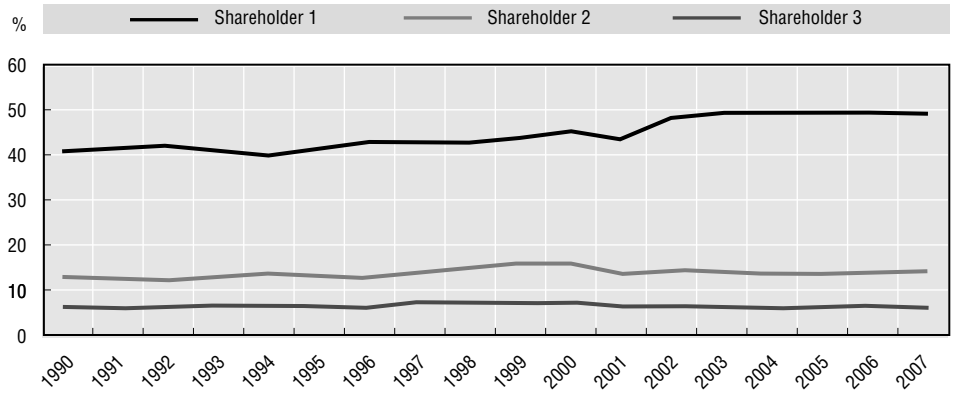
Of the 40 most traded firms, only four had a free float larger than 2/3 of equity in 2007, which implies that the remaining 36 were subject to significant control, since Chile's company law requires a super-majority of two thirds of voting capital for certain major decisions, giving a controlling shareholder at least blocking power in such cases. Similarly, only 16 of the 138 firms in the IGPA index as of September 2007 needed to obtain the votes of minority shareholders for such decisions. Despite the existence of such pyramid structures, controlling owners in Chile typically own far more equity than is necessary for effective control.

To measure ownership concentration, the international literature usually considers the sum of the three largest shareholders, given that companies in countries like the US or the UK are widely held. In the Chilean case the main shareholder -on average- owns 44% of the company (Morales, 2009), followed by shareholders owning 13% and 6% of the shares, respectively (Figure 3.4).

Conglomerates in Chile are not structured around banks, although a few have a bank within their company group, because banks were forbidden from owning equity in non-financial companies since 1986. The 1986 banking law also imposed strict controls on related lending due to its role in the 1982-83 banking sector collapse (credit to related parties amounted to 19% of total loans in 1982).

Indications of how much these control groups may be used to exert disproportionate control and minority expropriation can be discerned from the size of the control premium found in changes of corporate control. One study (Lefort and Walker, 2000) analysing 12 major acquisitions involving changes of control between 1996 and 1999 found an average control premium of 70%. However, the abnormal return was 5% for the stock after control was transferred, suggesting that the transfer also added value in the eyes of minority

Figure 3.4. **Market ownership concentration (three largest shareholders)**



Source: Morales, M., "Determinants of Ownership Concentration and Tender Offer Law in the Chilean Stock Market" Superintendencia de Valores y Seguros, *Serie de Documentos de Trabajo*, No. 1, 2009, available at *www.svs.cl/sitio/publicaciones/doc/Serie%20de%20documentos/morales.pdf*.

shareholders. The study used these results to estimate the total private benefits of control at approximately 25% of the value of common shares.

The predominance of company groups, high ownership concentration, indications of private benefits of control and low liquidity in Chilean markets are characteristics that may weaken the effectiveness of market mechanisms, leading the Chilean authorities' to conclude in 2008 that "the central corporate governance challenge in Chile is the risk of minority shareholder expropriation at the hands of controlling shareholders". The expectations for institutional investor engagement should be seen in this context.

3.1.4. Pension funds and other institutional investors

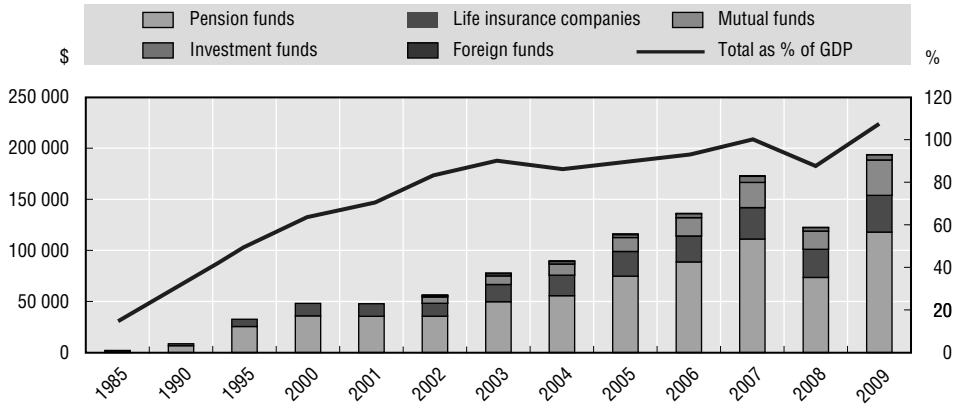
The Chilean capital market is characterised by the prominence of pension funds as the largest institutional investors in the market, followed by foreign investors and mutual funds. By far the most relevant are pension funds, whose transactions accounted for 52% of trading volume in the Chilean stock exchange in 2007. These funds, representing the pension savings of more than 8 million workers are precisely the minority shareholders that face the risks that preoccupy the Chilean authorities.

The early development of Chilean capital markets was partly propelled by the reform to Chile's privately-owned pension system designed in 1980, with a mandatory contribution scheme. The assets of institutional investors, as a percentage of GDP, have gradually increased during the last three decades. Among them, pension funds (currently divided in 6 privately-owned AFPs) represented about 65% of GDP by the end of 2009 (Figure 3.5). In addition, almost half of the investment funds are owned by pension funds,[2] so their share on total institutional investment is sizeable.

The pension fund managers have been allowed to invest in equities since 1985. Their investments have represented a significant contribution to financing the corporate sector in the country (Figure 3.6). According to testimony of the local experts, as much as half of all corporate bonds ever issued by the market have been bought by the AFPs (Table 3.2).

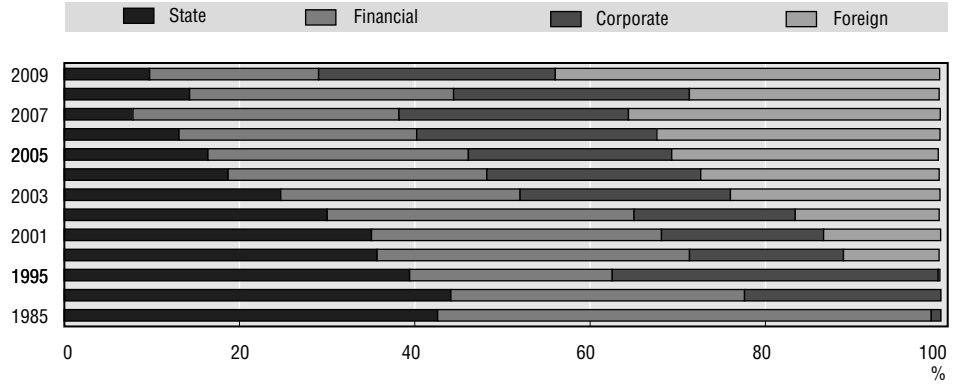
By the end of 2009, the AFPs had USD 15 billion in local equity, representing 6.9% of the total SSE capitalisation (Figure 3.7). While this percentage may appear relatively small, pension funds' influence is enhanced by the existence of cumulative voting provisions and

Figure 3.5. **Assets under administration by type of Institutional Investors**



Source: SVS Superintendencia de Valores y Seguros, *Estadísticas del Mercado Asegurador*, available at *www.svs.cl/sitio/estadisticas/seg_mercado.php*, and Estadísticas del Mercado de Valores, available at *www.svs.cl/sitio/estadisticas/valores_vision_archivos.php*.

Figure 3.6. **Evolution of pension fund portfolios (per sector)**



Source: SP Superintendencia de Pensiones, *Centro de Estadisticas*, available at *www.spensiones.cl/safpstats/stats/.sc.php?_cid=46*.

the co-ordination among pension funds and other institutional investors to elect independent directors.[3] These directors play an important role within Chile's Directors' Committees, with responsibilities similar to an audit committee in making recommendations to the board on related party transactions, appointment of auditors and others.

However, as indicated above, pension funds face limited liquidity in the Chilean domestic market, constraining the choice of actively traded stocks in which they can invest. This has been mitigated by relatively recent pension law reform that relaxed limits on how much pension funds can invest overseas. A cap on investments by AFPs outside Chile has been gradually lifted, from 6-12% in 1999 to a current global maximum of 80%.

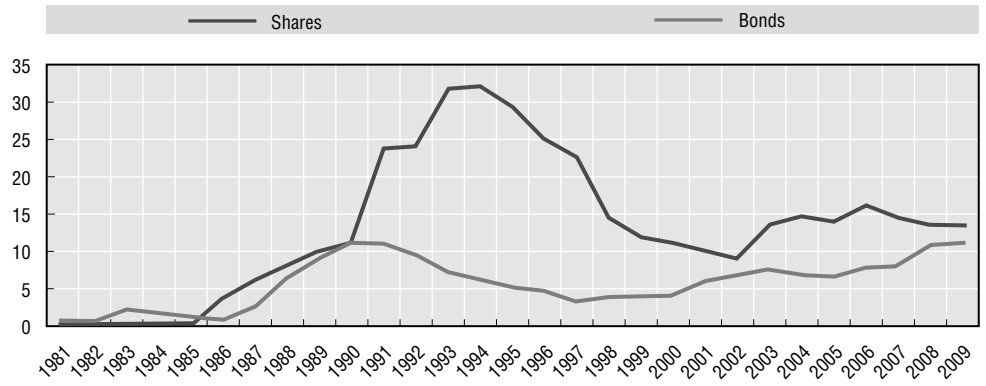
Recent reforms have also created a wider spectrum of choices for workers' savings, with each AFP having to offer five risk-differentiated funds, with proportions devoted to equity ranging from 5% in the lowest risk fund to as high as 80% in the most risky. This has had implications for corporate governance, as higher concentrations of equity investments

Table 3.2. **Pension funds' investments in Chilean corporate assets**

	Contribution of Pension Funds to finance the corporate sector								
	Equity			Bonds			Investment funds		
	Total	Pension funds		Total	Pension funds		Total	Pension funds	
	(MMUSD)	(MMUSD)	(%)	(MMUSD)	(MMUSD)	(%)	(MMUSD)	(MMUSD)	(%)
1985	2 012	0	0.0	222	17	7.6			
1990	13 619	754	5.5	1 256	744	59.2			
1995	71 177	7 471	10.5	2 410	1 334	55.4			
2000	60 514	3 984	6.6	3 643	1 448	39.7			
2002	48 110	3 210	6.7	6 541	2 535	38.8	1 256	795	63.3
2003	85 534	6 735	7.9	9 681	3 806	39.3	1 852	1 358	73.3
2004	116 212	8 173	7.0	11 463	3 803	33.2	2 422	1 479	61.1
2005	135 873	10 402	7.7	13 756	4 952	36.0	2 513	1 923	76.5
2006	173 873	14 306	8.2	15 066	6 948	46.1	4 019	2 952	73.5
2007	213 364	16 110	7.6	18 645	8 822	47.3	5 841	4 106	70.3
2008	132 595	9 932	7.5	18 216	7 896	43.3	3 230	1 890	58.5
2009	230 837	15 860	6.9	27 522	13 127	47.7	4 845	2 811	58.0

Source: SP Superintendencia de Pensiones, *Centro de Estadisticas*, available at *www.spensiones.cl/safpstats/stats/.sc.php?_cid=46* and SVS Superintendencia de Valores y Seguros, Estadísticas del Mercado de Valores, available at *www.svs.cl/sitio/estadisticas/valores_vision_archivos.php*.

Figure 3.7. **Pension fund investment in Chilean corporate assets (as % of total assets)**



Source: SP Superintendencia de Pensiones (2011b), *Centro de Estadisticas*, available at *www.spensiones.cl/safpstats/stats/.sc.php?_cid=46*.

allow for greater voting power. AFPs have a ceiling of 7% of any individual issuer's equity. While such limits significantly constrain individual pension funds' potential impact on governance, by eliminating the possibility of becoming controlling shareholders, collective pension fund actions may be powerful. The law expressly permits them to co-ordinate their votes and use cumulative voting in order to attain the 12.5% of votes necessary to secure the election of a director in a 7-member board.[4]

Mutual funds and insurance companies had about USD 35 billion each in assets under management by the end of 2009, but almost entirely invested in fixed income instruments. This is why among the key institutional investor groups involved in the market, pension funds are clearly the dominant players.

A final important investor group in Chile is represented by foreign investors. Exact information on how much foreign investors hold in Chilean equity is not available, but in 2007 the Chilean authorities estimated that USD 3.8 billion was a "lower floor", while the Central Bank estimated foreign investors' net portfolio of investment in Chile, with equity not separated at USD 9.3 billion.[5] Moreover, foreign multinationals control several prominent local companies, including one of the largest banks, Banco Santander, as well as Endesa and Enersis (the largest electricity generator and its holding company, respectively), Telefónica-CTC, D&S (retail), and IANSA (sugar).

3.2. Legal and regulatory framework

3.2.1. Disclosure obligations

Principle II.F states that:

"The exercise of ownership rights by all shareholders, including institutional investors, should be facilitated: 1) Institutional investors acting in a fiduciary capacity should disclose their overall corporate governance and voting policies with respect to their investments, including the procedures that they have in place for deciding on the use of their voting rights. 2) Institutional investors acting in a fiduciary capacity should disclose how they manage material conflicts of interest that may affect the exercise of key ownership rights regarding their investments."

As mentioned, Chile's corporate governance framework for institutional investors has focused heavily on pension funds (Box 3.1), and only slightly on other classes of institutional investors such as mutual funds or insurance companies. This is attributed to the fact that the size of pension fund investments in the equity markets is much larger proportionally and therefore more influential.

Existing regulations require pension funds to disclose their overall corporate governance voting policies. They are moreover obliged to attend shareholder meetings and exercise their voting rights in cases where they hold more than 1% of a corporation's equity. Pension fund administrators are also prohibited from voting for a board candidate related to the controlling shareholder, and must publicly disclose their voting intentions and proposed candidates. With the Pension Fund Reform of 2007, AFPs can now only vote for independent directors and must propose suitable candidates previously included in a register held at the SP. During the shareholder meetings AFPs are mandated to vote "*a viva voce*" for their candidates to the board, leave record of their votes on any relevant issue for the company, as well as report their votes to the SP.

The 2007 reforms also instituted a number of governance reforms for the pension funds themselves, an important step in view of the potential for conflicts of interest involving banks (*e.g.* BBVA and Citigroup) and other economic groups that are listed among Chile's main shareholders of pension funds. Thus, Chile's pension funds are now required to adopt investment policies and mechanisms to deal with conflicts of interest, to be approved by the pension fund board, and to be disclosed on the fund's web site, to the SP and to a Commission of Users of the System. Further reforms require the appointment of a minimum of two independent (referred as autonomous[6]) directors to pension fund administrator's boards, and the establishment of a directors' committee to review investments and conflicts of interest that must include independent directors among its members.

By contrast, the regulatory framework for oversight of investment funds and insurance companies is not as comprehensive about governance-related requirements, including no current requirements to report on voting policies. Investment funds and insurance companies are not obligated to make public disclosure of their engagement with investee companies, but have to inform only the SVS about general policies. In terms of conflicts of interest, the Securities Market Law (Article 230) requires managers of open and closed funds to determine how they will manage potential conflicts involving different funds administered by them. In addition, given the risk-based approach followed by the SVS, mutual funds' managers are required[7] to develop policies specifying procedures to identify and manage conflicts of interest. Mutual fund managers and insurance company's managers are also subject to regulation about conflicts of interest contained in the Corporations Law, in terms of related party transactions. Similarly, the board of insurance companies is required by the Insurance Law to inform the regulator about general policies adopted in terms of investments, financial risk management (use of derivative assets), and internal control.

In accordance with a recent amendment to the Law on Corporations, listed companies have the obligation to disclose the votes of each of the shareholders in the shareholders meeting, which indirectly allows the public to know how mutual fund administrators and insurance companies are exercising their voting rights. Unfortunately, this information is not accessible electronically but hardcopies are available at the offices of the regulator, which makes it almost impossible to research.

On the other hand, AFPs have to inform about their investment policies and the way they would solve potential conflicts of interest as investors. Each AFP has taken specific positions in terms of corporate governance issues, mainly on the eligibility requirements for independent director candidates that would be supported by them, as well as regarding compensation to members of the board. For example, one AFP has stated that a director elected with its votes cannot stay more than six years on the same board and cannot be elected as independent director in more than two boards simultaneously. Actually, starting as of year 2011 the SP requires AFPs to report in their investment policy about principles and corporate governance practices they will consider on the companies where the funds are invested.

Finally, beyond the regulatory framework, some pension funds have issued their own codes and regulations. Since 2007 one AFP has a corporate governance code promoting best practices for Chilean companies. In this document, the AFP defines its position on the main issues of corporate governance for the companies, making explicit what policies would or not be supported by the AFP.

3.2.2. Shareholder rights

Principle II.G states that:

> "Shareholders, including institutional shareholders, should be allowed to consult with each other on issues concerning their basic shareholder rights as defined in the Principles, subject to exceptions to prevent abuse."

The Chilean Corporation Law does not promote or prevent co-ordination among shareholders, but such co-ordination does take place. In practice, the pension funds as the dominant institutional investor class actively work with other institutional investors and minority shareholders, particularly in relation to voting for independent directors. For a

board candidate to be eligible to obtain the support of AFPs, he or she must be included in the Register of Directors at the SP. Those candidates have to satisfy the minimum standards in terms of academic qualifications, and to inform of any conflict of interest to be director of a specific company where the AFPs have their investments. In addition, AFPs are forbidden to vote for a candidate related to the main shareholders of the company (including family members or members of management in a company controlled by the main shareholders). Starting in 2008 the AFPs have delegated the selection of suitable candidates to executive search consultants, making the whole process more transparent and helping to expand the pool of professional directors at Chilean companies.

Considering that – by regulation – the investment of a single AFP cannot be more than 7% of a company's equity, they are allowed by law to vote as a group in order to maximize the number of independent directors on the board. As most companies have a large controller shareholder already, there is little risk of abuse in relation to their collaboration with others. Rather, as in the case of takeovers, they are more likely to co-ordinate in the negotiation of what may constitute a better treatment for their minority shares. Cases have also been documented of minority shareholders co-ordinating their position in relation to appointment of external auditors, and in relation to the level of pay for board members or executives.

Mutual funds are also forbidden to participate in the management of the company where they invest their resources, but the Securities Market Law allows them to actively search agreement among themselves and with other minority shareholders for board nomination and elections. For the rest of institutional investors, there is no specific regulation on shareholder co-operation.

3.2.3. Shareholder responsibilities and fiduciary duties

In their role as shareholders of publicly traded companies, institutional investors in Chile are in general not affected by specific regulations beyond those that affect general shareholders.

However, the 2010 reform to the Mutual Funds Law introduced the obligation for open funds – owning more than 1% of a company – to vote in the election of the board. There is no mandatory rule for insurance companies, closed mutual funds, investment funds or foreign funds. As mentioned, this could be due to the lower amount of their investments that are allocated to equities, or to the costs associated with monitoring, given the investment strategies of these institutions (short-term horizon, diversification, etc.). This doesn't mean there are no fiduciary obligations for mutual funds. The Securities Market Law requires fund managers to look after the best interest of their clients. They are required to manage the funds with the same diligence as if they were attending their own business, looking for an adequate trade-off between risk and return for the corresponding portfolios.

In contrast with the institutional investors mentioned above, the shareholder obligations of AFPs are tightly defined by the law and supervised by the pensions regulator. This differentiated degree of control on AFPs is often explained by the fact that the Chilean pension system is mandatory, fully funded (defined contribution) and operated by the private sector (only 6 firms by 2011). This makes the fiduciary role of AFPs an objective to be carefully supervised by the authorities in order to ensure a responsible investment of workers' retirement funds.

Box 3.1. **Pension funds main regulation regarding Principles II F and G**

Under Decree Law (D.L.) No. 3.500 of 1980, the Pension Funds' Investment Regime, private pension fund administrators are required to adopt investment and conflict of interest policies. They must publish them on the AFP's website. The minimum content of the investment and resolution of conflict of interest policies must include the existence of procedures, manuals and codes of conduct guiding the exercise of their role as investor. They must also refer to matters that include the requirements and procedures for selecting candidates to the boards of the listed companies in which they invests. The directors for whom the AFPs vote must be included in a Registry of the Pensions Superintendence. A new requirement that came into force on March 2011 demands that these investment policies must also refer to the criteria and measures adopted in relation to the corporate governance and practices of the companies in which they invest. In addition, guidelines on good corporate governance have been drawn up voluntarily and made public.

AFPs have an obligation to attend shareholders' meetings, to vote publicly and to explain the grounds for their votes. They must attend all the shareholders' meetings of those companies in which the pension fund has invested, providing they hold more than 1% of the subscribed capital. Under that level it is however necessary for them to participate in shareholders' meetings when the votes of the entire AFP system are relevant to make an important decision for the company, such as the election of an independent director. They must be represented by individuals appointed for this purpose by the board of directors. These representatives cannot act with powers other than those conferred on them and must always express an opinion, *viva voce,* on the agreements adopted by the shareholders meeting and ensure that their vote is recorded in the corresponding minutes.

The AFPs must file a monthly report with the Pensions Superintendence, setting out their attendance and participation in shareholders' meetings. In this report, they must also set out the grounds for their vote on the following matters: *i)* election or removal of directors and alternate directors, the directors' committee and the adjusters and inspectors of the administration; *ii)* the company's investment and financing policy; *iii)* distribution of the period's profits and payment of dividends; *iv)* observations about its financial statements; *vi)* all those matters that correspond to an extraordinary shareholders' meeting in accordance with the Corporations Law. The Pensions Superintendence carries out an annual evaluation of AFPs' compliance with the obligations and then publishes a report of compliance.

In the election of directors in the companies in which the AFPs invest the candidates for which the AFP's representatives will vote must be decided by the AFPs board. The board must also establish the criteria to be followed by its representatives if the pension fund's interests require them to vote for a candidate other than the one selected by the board. These decisions must be recorded in the minutes of the board meeting along with the grounds on which they were taken. An AFP representative who votes for a candidate other than the one chosen by the board must present a written report to the subsequent board meeting, setting out the reasons for this action and the circumstances. This must be noted in the meeting's minutes along with the board's opinion about this action.

Pursuant to the D.L. No. 3.500, pension funds may not invest directly or indirectly in instruments issued or guaranteed by persons related to the AFP. As a result, conflicts of interest related to investments do not, in general, arise. However, as indicated above, investment and resolution of conflict of interest policies are public.

Box 3.1. **Pension funds main regulation regarding Principles II F and G** *(cont.)*

AFPs may act in consultation with each other or other shareholders, except the majority shareholder or those related to the majority shareholder, in electing the directors of the companies in which the pension funds invest. They may not, however, take steps that imply participating or being involved in companies in which they have elected one or more directors. In practice, AFPs have jointly commissioned studies and reports and hired consultancy services to help them take better decisions in shareholders' meetings (for example, when strategic assets have been sold or for approving the price of a tender offer). However, in these cases, the decision on how to vote is taken individually by each AFP. In several cases the AFPs have taken joint legal action.

Source: Chilean responses to the OECD questionnaire.

In addition, given the low liquidity observed in the Chilean stock market, AFPs are not able to "vote with their feet". Just selling shares whenever they don't agree with corporate governance practices of a company is not an attractive option, essentially because of the size of pension funds in the market, as well as the herding behaviour among AFPs. The liquidity premium paid in such a transaction would cause an important loss for workers' retirement savings.

The AFPs are therefore forced to participate in shareholder meetings to represent workers' retirement savings in all companies where they hold more than 1% of equity. These obligations also extend to bondholder meetings, where the AFPs have gained a reputation as tough negotiators with companies that fail to meet a bond covenant. The objective behind these regulations fostering engagement and collective action is to ensure that AFPs will monitor their investment carefully. But at the same time the rules prevent their engagement to go further, prohibiting their involvement in the management of the companies where they invest.

3.3. Exercise of shareholder rights

There are two main sources of evidence on the role of AFPs in promoting good corporate governance practices by Chilean companies. First, a summary of the mandatory reports of AFPs participation in shareholder (and bondholder) meetings can be obtained from the Pension Superintendence. These summary reports present statistical information on the election of directors supported by the AFPs, as well as the role of AFPs in important decisions adopted in some of the meetings. On the other hand, there are several prominent cases where the role played by some AFP was crucial in setting corporate governance standards in the country (addressed in Table 3.3).

Between 2007 and 2010 AFPs have elected one or two directors in 60% to 70% of the companies renewing their boards. These figures are interesting when considering that the sum of the share of AFPs ownership is less than 20% in 90% of these companies. This means that AFPs should not have been able to elect such a number of independent directors with their own votes alone. They must vote together with other minority shareholders in order to reach the minimum vote required to elect them. These agreements or correlated votes are evident in 2010, for example, where 11 independent

directors were elected in companies where AFPs controlled less than 50% (and 27 independent directors were elected in companies where they held between 50% and 100%) of the minimum votes required to elect a member of the board (Tables 3.3-3.6).

Table 3.3. **AFPs ownership in companies renewing boards per year**

Percentage

Participation	2007	2008	2009	2010
Greater than 20%	8	6	6	9
Between 10 and 20%	22	16	29	30

Source: SP Superintendencia de Pensiones, "Informe de asistencia y participación de las administradoras de fondos de pensiones en juntas de accionistas, juntas de tenedores de bonos y asambleas de aportantes de fondos de inversión, nacionales", several years, available at *www.safp.cl/573/propertyvalue-1848.html*.

Table 3.4. **Companies renewing their boards by year and by size of the board**

Percentage

Size of board	% to elect a director	Proportion of companies renewing board members			
		2007	2008	2009	2010
5	16.67	3.1	3.9	8.20	0
6	14.30	1.6	2.0	4.10	2
7	12.50	56.3	68.6	55.10	72
8	11.11	12.5	0.0	2	0
9	10	21.9	19.6	22.40	26
10	9.09	0.0	2.0	4.10	0
11	8.33	4.7	3.9	4.10	0

Source: SP Superintendencia de Pensiones, "Informe de asistencia y participación de las administradoras de fondos de pensiones en juntas de accionistas, juntas de tenedores de bonos y asambleas de aportantes de fondos de inversión, nacionales", several years, available at *www.safp.cl/573/propertyvalue-1848.html*.

Table 3.5. **Directors elected by AFPs by company according to % of votes**

	Directors elected			
	2007	2008	2009	2010
Greater than 100% of required % to elect a director	12	4	13	6
Between 50% and 100% of required % to elect a director	16	14	15	27
Less than 50% of required % to elect a director	14	8	4	11

Source: SP Superintendencia de Pensiones, "Informe de asistencia y participación de las administradoras de fondos de pensiones en juntas de accionistas, juntas de tenedores de bonos y asambleas de aportantes de fondos de inversión, nacionales", several years, available at *www.safp.cl/573/propertyvalue-1848.html*.

Table 3.6. **Percentage of companies where AFPs elected one or more directors per year**

Percentage

Number of directors elected by pension funds	2007	2008	2009	2010
None	0	38	33	28
1	66	44	50	46
2	24	18	11	21
3	10	0	6	5

Source: SP Superintendencia de Pensiones, "Informe de asistencia y participación de las administradoras de fondos de pensiones en juntas de accionistas, juntas de tenedores de bonos y asambleas de aportantes de fondos de inversión, nacionales", several years, available at *www.safp.cl/573/propertyvalue-1848.html*.

Furthermore, in order to select their candidates to the board, the pension funds have for a few years already collectively retained the services of executive search consultants. They are given precise instructions by pension funds managers as to the professional profile and qualifications of candidates that would fit the needs of the respective company board. Managers report that by doing so they have managed to broaden the scope of candidates, professionalize the process and distance themselves personally from the screening of candidates.

This has affected the profile of independent directors elected with the support of the pension funds' votes. Candidates are increasingly characterized by a professional and technical profile. This is reflected in a significant proportion of master and Ph.D-holding board members (Table 3.7). This is in line with the goal of improving the competences of boards by introducing analytical and strategically oriented directors. Overall, the role of AFPs and other institutional investors in increasing the number and qualification of independent members of the Boards has been recognised in surveys of Chilean companies (McKinsey, 2007) as significantly enhancing corporate governance practices.

Table 3.7. **Independent directors' profile**

Percentage

Academic profile of independent directors elected				
Academic degree	2007	2008	2009	2010
Professional	72	25	36	39
Master	23	52	42	47
PhD	5	13	22	14

Source: SP Superintendencia de Pensiones, "Informe de asistencia y participación de las administradoras de fondos de pensiones en juntas de accionistas, juntas de tenedores de bonos y asambleas de aportantes de fondos de inversión, nacionales", several years, available at *www.safp.cl/573/propertyvalue-1848.html*.

3.3.1. Explanatory factors

Interviews with managers of pension funds confirm their strong engagement with domestic companies, which they attribute to basically three factors: *i)* above all, the small size and reduced liquidity of the market; *ii)* the admitted heard behaviour of pension funds, and *iii)* historical and regulatory reasons.

With controlling shareholders owning about half of the shares of domestic listed companies, the average holding by all institutional investors leaves little room for liquidity in the market. In 2010 AFPs alone held equity in 101 listed companies out of the 230 shares making up the IPSA index. They owned on average 6.4% of the shares of each issuer, fluctuating from 26.3% to 0.0001%. Those few relevant listed companies are precisely those that would give the AFPs the exposure to the Chilean equity market they seek, so there is not much option for investors to further diversify their domestic equity holdings beyond those 100 firms.

Low liquidity and a small market act as constrains on pension funds' portfolio and, according to their own testimony, force a buy-and-hold strategies. "Since there is no way out, the reasoning is that we better make sure we use our influence to get the best returns we can" stated a pension fund manager interviewed for this report. Most pension funds claim to monitor closely about 70 domestic companies with their own small internal

research departments (two to ten researchers), although many accused a degree of free riding from other funds and institutional investors.

Chilean pension funds compete for the workers' savings, which are obliged to contribute but can choose the administrator of their choice. Every quarter, the SP publishes a ranking of returns by pensions funds. This is said to have a big influence on choices by individuals, especially newcomers. Managers explain that 10 basis points of advantage on the portfolio return in a given quarter may not make a big difference for future pensions, but may put their management company on top of the ranking, which could make a big difference for their evaluation as managers. This competition takes place mostly within fixed income and on foreign investments, where managers make small, calculated bets that would provide for enough returns so as to beat the competition while not risking much in case the investment fails.

Heard behaviour in domestic equity portfolios has been well documented and is openly acknowledged by pension fund managers. According to the testimony of managers interviewed for this review, they do not compete on the domestic equity market. The Chilean authorities say that AFPs' equity investments have remained stable in time and they cannot be considered as excessively focused on the short-term. In fact, their behaviour has involved effectively monitoring and prompting change in the policies of the companies in which they invest (mainly related to investments, leverage, board remuneration and the definition of essential assets).

One explanatory factor for this heard behaviour is that pursuant to the Chilean pension system design, AFPs have to guarantee workers a return of at least 50% of the industry return of the prior 36 months, so there are very few incentives for them to assume high individual risks that could make them depart from the mean. Beyond that, managers also mention that the unwritten consensus is that the domestic equity market is "a neutral territory". "We do not compete with local shares and when one buys in, we all do. We cannot afford to take differentiated risks here." The unintended effect of this is that since they all have the same portfolios, co-ordination is somehow a rather natural consequence.

When the Chilean privately-run pension fund system was launched in the 1980s, the ruling military government warned the economist and engineers' behind the proposal that they had better made sure that the system would not lose the workers' savings, as that could lead to additional political unrest which the de-facto regime could not afford. This conservative approach permeated the entire system, from the types of investment allowed to the early adoption of required voting and encouraged co-ordination rules. Managers at pension funds acted from the early stages under the assumption that they had a strong fiduciary duty, and engaged with firms even beyond the minimum legal requirements.

Moreover, the system also has economic incentives for aligning the interest of the fund managers. AFPs have a legal requirement to set aside capital for the equivalent to 1% of their assets under administration, which must be invested in the five pension funds administered by them, pro rata to their relative size. This represents a considerable investment of the AFPs own resources, adding up to more than USD 1.4 billion by December 2010 (SP, 2011b), aligning the incentives in the direction of increasing the return of the portfolio of the workers' savings, as it is common in the private equity or venture capital industry.

All these factors have shaped a general institutional investor attitude towards engagement with investee companies, affecting the way in which they exercise their shareholders rights, at least in the domestic market. Even though the legislation is not as explicit as in other countries establishing a clear distinction between local engagement and the duties of pension funds with respect to their foreign holdings, both the interpretation of the authorities and the practice of funds mark a sharp difference between domestic and foreign companies. "Abroad we do not engage but with our asset managers, every trimester, and mostly to measure them against the agreed benchmark" was the position of one pension fund manager. Others confirmed their passivity with regards to individual companies, but claimed more monitoring of the asset managers, including regular inspection visits and due diligence. None admitted considering the degree of engagement of the asset manager with the individual investment as bearing any real relevance. Voting policies, voting records and the like, were not really considered. They would not ask to be given the chance to decide their proxies, nor to know the general stand of the asset manager with respect to voting, if it used or followed a proxy advisor or not. The real concerns, managers explained, are often only the reputation of the manager and past performance.

When required to explain this different engagement approach between domestic and foreign equities, the responses referred to the size of companies, the relative weight of their ownership on the fund's portfolio, the small size of their research teams and the high cost of research on foreign equities. But above all, their attitude was marked by their understanding that they were investing in a market (be it the Russian or the Chinese markets), and not in the individual companies that composed the portfolio. They were clear that they wanted exposure to the market risks and return, and that their investment horizon was very short. If a manager failed to deliver in comparison to the benchmark, a new manager would be quickly selected.

Box 3.2. **Case studies of institutional investors engagement**

In terms of emblematic cases, following Lefort (2007) they can be divided based on what corporate governance issue was affected by the actions taken by AFPs. These cases involve: *i)* minority shareholder rights, *ii)* composition and functioning of the board; and *iii)* remuneration of the board. In all these cases the AFPs have satisfied their fiduciary duties by exercising their minority shareholder rights, as well as enhancing the functioning, composition and incentives for the board in the best interest of shareholders.

i) Minority shareholder rights

- The "Chispas" case (1997): The AFPs challenged the agreement between ENERSIS and ENDESA Spain to obtain the control of ENDESA Chile. The AFPs called for an extraordinary shareholders meeting where they obtained a better deal for minority shareholders out of the new acquisition plan proposed by ENDESA Spain. This case was an important element in the later development of the tender offer reform adopted by Congress a few years later.
- Acquisition of Telefonica Net by Terra (1999): The AFPs considered that the price offered for Telefonica Net was under market value. Independent directors, elected with the support of AFPs, were also in disagreement with the transaction. AFPs representatives rejected it during the shareholders meeting, but the controller managed to obtain the necessary votes. The transaction was completed, and the pension funds filed a law suit asking for compensation for Telefonica Net. It did not prosper.

Box 3.2. **Case studies of institutional investors engagement** *(cont.)*

- Asset sale between Telefonica CTC and Telefonica Moviles (2004): The AFPs called for an extraordinary shareholders meeting to challenge the conditions under which the mobile business of Telefonica CTC would be bought by its related company, Telefonica Moviles. The original price was subsequently increased by USD 50 million, and Telefonica CTC agreed to pay an extraordinary dividend of USD 800 million.
- Merger MASISA-Terranova (2004): The AFPs obtained a better exchange ratio between shares of the two companies, as well as an extraordinary dividend of USD 54 million.
- Amendment to Soquimich's charter (2005): The AFPs gave support to Potash Corporation to change the statutory charter of SQM in order to unify the rights of the two series of shares, as well as to impose a cap of 37.5% on the voting rights for any given group of shareholders under a shareholders agreement.

ii) Composition and functioning of the board

- FASA (2009): The AFPs asked for the dismissal of top managers of the company and the renewal of the board, after it was made public that the managers and the Chairman failed to inform the board (in order to by-pass the independent directors) about a leniency agreement the company had reached with the Chilean competition authority. The company had been accused of price collusion with the two other big pharmaceutical companies in the country. The reason given by the Chairman (also the controlling shareholder of the company) for not informing independent directors about the agreement, was the lack of confidence he had in them. He argued that because of their relationship with some other companies from the pharmaceutical industry related to the collusion case, independent directors should not be trusted. The Securities Regulator imposed a fine on the Chairman, as well as to all the individual members of the board due to their passivity on satisfying their obligation to be informed. The board was partially replaced, with all the members elected by the Chairman, including him, stepping down. Top managers were also replaced. Subsequently the Chairman sold the company.

iii) Remuneration of the board

- La Polar (2006): One AFP proposed a new compensation scheme for the board, where earnings would be shared with the board only if profits had reached a minimum threshold that would provide for adequate return for shareholders. It also contemplated that additional compensation should be paid to directors closely related to the management of the company, with a performance evaluation process for the board. It also included stocks options with the restriction of not selling them for a two year period. The proposal was approved with almost 90% of votes and the support of the rest of the AFPs.

3.4. Conclusions

The Chilean securities market presented challenges to the institutional investors, mainly with high ownership concentration, a relatively small listed sector and low liquidity. The policymakers and the institutional investors, particularly the pension funds, faced those challenges with co-ordination and engagement, promoting investors' interest but at the same time shaping the Chilean corporate governance framework.

Unlike in other markets, the Chilean authorities were not concerned about institutional investors acting in concert, as most Chilean listed companies had and still have controlling

shareholders owning almost half of the issued shares. This has allowed co-ordination and collective engagement to go even beyond the few areas where the law encouraged it, in many cases with positive consequences for the whole market. Many factors have wrought this outcome, from policy design to controversial cases, but all demonstrating that institutional investors may have a role to play even in concentrated and small markets.

The influence of institutional investors in the behaviour of domestic companies is well documented by papers and reflected in real cases, perhaps showing that the criticism about investor passivity that rose after the recent financial crisis is not applicable worldwide. However, many of those same criticisms are entirely applicable with respect to the foreign investments of Chilean pension funds. There, the short-term focus, the lack of interest on voting and the focus on benchmarks rather than on company performances, are all true.

In terms of compliance with Principles II.F and II.G, Chilean laws and regulations broadly meet the standards considered for institutional investors. This is particularly clear in the case of pension funds, both in the text of the rules and in the practices. In the case of insurance companies, mutual funds and investment funds, perhaps due to lack of closer attention in the past, the rules and regulations are still insufficient, but many are going through upgrading exercises or have been targeted for future amendments.

In sum, Chile has been successful in crafting rules and special powers for institutional investors that meet their unique market and corporate structure.

Notes

1. Sections 3.1.1 to 3.1.3 of the report are mostly extracted from OECD (2010), *Corporate Governance in Chile*, OECD Publishing, available at *http://dx.doi.org/10.1787/9789264095953-en*, which was prepared as part of the process of Chile's accession to OECD membership.
2. Pension funds buy investment funds as a way to increase their exposure to high yield assets (mostly shares) when they reach the limit for direct investment, as defined for the portfolios types in the regulation of pension fund investments.
3. Under the 2009 Corporate Governance Law, independent directors who previously could be elected only by minority shareholder votes are now defined in relation to economic and relational criteria, and may be elected by the votes of all shareholders. It is important to note that independent directors elected with the support of institutional investors have the same rights and obligations as any other member of the board, and by no mean should they give any information to them which is not simultaneously available for the rest of the shareholders or even for the market.
4. The 12.5% share necessary to elect a board member applies to boards with seven directors, the minimum number required by law. Some corporations voluntarily have larger boards, in which case a smaller percentage of votes is required.
5. OECD (2010).
6. Autonomous pension fund directors are defined in relation to economic criteria. Their independence is also reinforced by requirements that board members cannot serve in the legislature or as Ministers or deputy chiefs of public services during the 12 months following departure from their board position.
7. Circular 1869.

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PART II

Chapter 4

Germany: The Role of Institutional Investors in Promoting Good Corporate Governance

This chapter on Germany describes the structure of institutional investors both domestic and foreign. It then outlines shareholder rights and how institutional investors make use of such rights, including via *voting, and to monitor their investee countries. The regulatory framework under which they operate is outlined and a study reported on shareholder turnout at annual meetings of German companies.*

Institutional investors, their role, powers, and organisation have been a controversial issue in Germany. Indeed, at some times there has been outright hostility to some such as following the Deutsche Börse affair and another private equity transaction when they were famously characterised as "locusts". At the same time, it is important to note that financial institutions such as insurance companies and banks have always had an important role in Germany. Despite this rhetoric, the role of institutional investors, especially in the larger German companies has increased markedly in recent years raising a number of policy issues.

This review first outlines the corporate governance framework and landscape before documenting the situation of institutional investors. The following section discusses shareholder rights and how institutional are acting within this framework and the OECD Principles. A final section sets out conclusions.

4.1. The corporate governance landscape

4.1.1. Market concentration and control

Control of corporate Germany has evolved rapidly in the last ten years with an unwinding of cross shareholdings and the phasing out of voting caps and multiple voting rights that often underpinned corporate control. Germany for many years was characterised by extensive cross holdings especially by Deutsche Bank and Allianz insurance leading to the characterisation of Germany as a corporativist system (labelled by some as Deutschland AG). Bank borrowing was a significant source of corporate finance during the 1950s and the 1960s. In addition to their direct shareholdings, banks were also able to vote shares that they held on behalf of clients since they acted as depositories. Their own management also served on the supervisory boards of numerous companies. However, changes in capital gains taxation in 2002, higher capital requirements for banks and the implementation of new insider trading laws have led to a substantial unwinding of cross holdings in the last ten years. The presence of bankers as board members has also declined and they now emphasise that they are acting in a personal capacity. Since 1998 depositaries also need explicit approval to vote shares held as a custodian. Deutschland AG in its traditional form with numerous cross holdings and shared non-executive directorships and retiring CEOs routinely becoming chair of the Supervisory Board is very much becoming a thing of the past.

The ownership structure of German listed companies has now become quite dualistic with a number of enterprises still under tight control but others now have a broad ownership base. Table 4.1 indicates that many enterprises are characterised by large block holders: the median largest voting block is over 50% for the 20 largest companies and on par with Italy. Family wealth is also important with 20% of total stock market capitalisation controlled by the ten richest families. Families have traditionally established foundations through which to exercise their ownership rights. Pyramid ownership remains prevalent

Table 4.1. **Ownership concentration**

Percentage

	Widely held	Family control	Pyramid control	Median largest voting block	Family wealth
France	60	20	15	20	29
Germany	50	10	20	57	21
Italy	20	15	20	55	20
United Kingdom	100	0	0	10	6
United States	80	20	0	5 (NYSE) 9 (NASDAQ)	n.a.

Source: Jurgen Odenius (2008), "Germany's Corporate Governance Reforms: Has the System Become Flexible Enough?" *IMF Working Paper* WP/08/179, International Monetary Fund.

among such companies allowing a dominant shareholder to exercise control of one company through the ownership of another. However, the largest listed companies are quite different and are characterised by a very high free float[1]. Indeed, the free float of the largest 30 companies comprising the DAX increased from 64.5% in 2001 to over 80% in 2010 (DAI, 2010). The top ten companies dominate the equity market accounting for a third of the market capitalisation. Of these, half have a very high free float: Allianz SE and Munich Re had free floats of 100% and 90% respectively and Siemens, 95%.

4.1.2. Corporate law and company practices

Germany has a two tier board system with the management board (MB) appointed by a supervisory board (SB) which does not include any representatives of management. The MB is appointed for a fixed term (usually five years although the German code recommends an initial appointment of only three years) and they can only be removed for cause by the supervisory board. German takeover law grants the MB the right to interfere with takeover attempts allowing four different types of defensive measures. While some of these measures require shareholder approval, the MB with the approval of the SB may also use specified defensive measures without ad-hoc shareholder approval (if shareholders have approved previously actions for the eventuality of a future takeover), including the purchase or sale of important assets.[2] In any case, uninvited takeover attempts have been rare until recently due in part to the difficulty of being able to change the two boards.

An issue that has been taken up by institutional investors concerns "creeping control" (Porsche/VW, Schaeffler/Continenetal) that involved purchases in excess of the 3% and 5% threshold. Investors and companies called for enhanced reporting requirements to cover, for example, cash settled options. A change was enacted in April 2011. Another weakness recently applied in takeover cases is applying the law to raise control status cheaply after the initial hurdle of 30%, through avoiding to make a "mandatory offer" by making a "voluntary offer" when the stake is still below 30%. Companies can increase their stake further by buying additional shares on the open market without regard to the price of the "voluntary offer" and a control premium until the next disclosure threshold of 50% ownership.

The law mandates that Supervisory Boards in large companies (more than 2 000 employees) comprise a half labour representation (including three union representatives) but only one third in companies with between 500 to 2 000 employees. They are elected directly and not by shareholders. As a result, the SB are usually large

ranging from 12 to 21 depending on company capital. How the SB functions has been the object of long debate. Some observe that half the board representing the shareholders (including the chair who has a casting vote) usually meets in the morning to discuss company affairs separately. In the afternoon, the full board meets with more an emphasis on labour issues. Executive compensation used to be dealt with by the shareholder part of the board but since last year the whole board bears responsibility, shifting the balance of influence significantly. Finally, the need to ensure labour representation has prevented law makers from establishing requirements for professional skills for board members.

The role of the work force in the operation of a company is more significant than is indicated by representation on the SB. Works Councils have an important role including in the extensive training system. As a result, one observer argues that management of German companies is in continuous negotiation with employee representatives but that the system suits the innovation system and the emphasis on high quality manufactured products (Goyer, 2006). The normative model of the all powerful CEO does not hold. It is thus hardly surprising that German managers emphasise that companies belong to stakeholders and place a great emphasis on job security.[3]

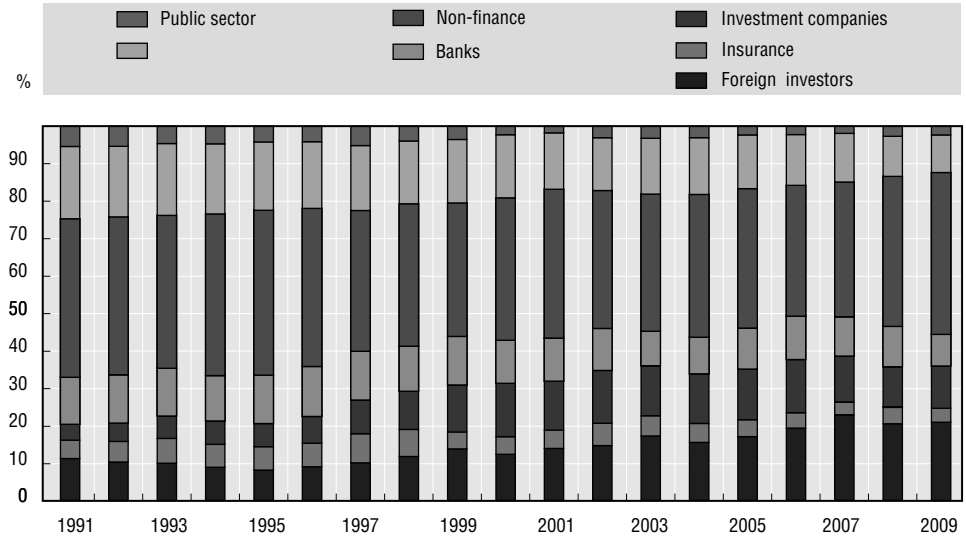
There is a new option for companies to register as Societas Europeae (SE) which gives them the option to choose between a two tier or one tier board system. The larger German companies that have chosen to take the SE form have retained the two tier system. The SE allows, regardless of the number of employees, a reduction in the number of SB members to 12 thus making the board more efficient. Since the representative of the employees must reflect the company's international operations, it also increases the international representation of the workforce. With these features, it is no surprise that Germany has the most SE incorporations in the EU.

In addition to company law, there is also a German corporate governance code (Kodex). Companies have to declare annually the "shall recommendations" with which they comply and explain any deviations. The Kodex makes important recommendations concerning shareholder rights (see below).

4.2. Institutional investors

As noted above, Germany has a long history of significant direct shareholdings in non-financial companies by the banking and insurance sectors as well as established corporate groups and pyramids. This is illustrated in Figure 4.1 by the high level of holdings by non-financial institutions, banks and insurance with a total share of around 55% of domestic equity. Of the institutional investors, investment companies are the most important with about a 10% equity share. Retail ownership both directly and indirectly has declined from in any case a low base and accounted for only 13% of the population in 2010, and around 10% of equity (Rúdiger von Rosen, 2010). At the same time, there has been significant inflows of equity investments from foreign institutional investors, apparently predominantly pension funds rather than mutuals although alternative investments such as hedge funds have also been active at times (Maurer, 2003). Foreign ownership increased from around 14% in 1999 to nearly 30% in 2007. It was still the second lowest in Europe after Italy (FESE, 2008). However, Figure 4.1 is misleading since it refers to the entire listed sector. For the thirty companies comprising the DAX, institutional investors (foreign and

Figure 4.1. **Equity holdings by all types of investors**



Source: Deutsche Bundesbank (2011), Time series database, available at *www.bundesbank.de/statistik/statistik_zeitreihen.en.php*.

domestic) own 70% of the outstanding shares and foreign ownership now exceeds 50% in a number of them. The policy interest in the question of institutional investors and their engagement is thus easy to appreciate.

Banks and insurance companies also act as depositories and have in the past often been able to vote a large proportion of privately held shares. There are special rules pertaining to the exercise of voting rights by credit institutions and professional agents when acting as a proxy agent. According to the law (Article 135 *Aktiengesetz*), a credit institution may only exercise voting rights attached to shares it does not hold (*i.e.* they are not in the share registry of a company) only if it has been authorised to do so by proxy. A credit institution which intends to exercise the voting rights of a proxy shall make available in a timely manner to the shareholder its own proposals for the exercise of the voting right with respect to individual agenda items. The voting power of depositaries was evident during the HP and Compaq takeover battle where the voting power of Deutsche Bank was said to have been crucial. The new German Shareholders Rights Act (*Gesetz zur Umsetzung der Aktionärsrichtlinie*, 2009) adapts the proxy voting powers of banks (*Depotstimmrecht*) and makes it more attractive for shareholders to grant proxy voting powers to them as well as to Shareholder Protection Associations (see below).[4]

The mutual fund is the most common type of investment fund in Germany. They are run by an investment management fund company (KAG) that is typically owned by a commercial bank or insurance company. The companies rather than the individual funds are subject to a comprehensive legal framework to protect investors' rights under the Investment Act (*Investmentgesetz*). The incorporated KAGs are required to have a supervisory board that has to represent the interests of the fund clients. It is, however, debateable whether Article 9 of the law that requires the company to act in the sole interest of the customer and the integrity of the market, includes the duty to exercise ownership rights as there are only a few legal cases concerning liability for mismanagement of investments. Article 32 of the *Investmentgesetz* states that institutional investors "should"

(*i.e.* it is not mandatory) exercise their shareholder rights "themselves" which some observers believe implies a duty to vote, except in certain circumstances. Some observers feel that it is this clause that has led to most investment funds voting their domestic shares. By January 2011 investors could choose between 6 668 mutual funds which were managed by 51 investment management companies (KAG and their Luxembourg subsidiaries). The largest KAG's are DWS Investment (a subsidiary of Deutsche Bank with assets under management of EUR 135 billion), Deka Investment (asset manager of the German savings banks, AUM EUR 103 billion) and Union Investment (subsidiary of the co-operative DZ Bank, AUM EUR 86 billion). A fund is managed on the basis of a management contract by the investment management company and the unit holders. Although such funds have expanded, their world market share has tended to decline, one reason advanced being that in Germany there are no tax benefits for long term savings with mutual funds.

With predominant ownership of investment management companies by financial institutions, there are clear potential conflicts of interest between the KAG's and investors. This issue is dealt with in part by regulation with respect to fund management companies but also until recently in great measure by the investment managers' BVI code of conduct (*i.e.* quasi self-regulation) (Box 4.1). German fund management companies have not been generally required to disclose their overall corporate governance policies and voting policy with respect to their investment (Principle II.F.1). Moreover, they have not been required to disclose how they handle conflicts of interest (Principles II.F.2). These requirements were handled by self-regulation of the industry (Box 4.1) that also encourages the exercise of ownership rights as a duty of investors. However, since January 2010, the German financial markets regulator (BaFin) uses Part 1 of the BVI code (*When performing its functions, the investment company (KAG) acts exclusively in the interest of the investors and the integrity of the market … The investment company endeavours to avoid conflicts of interest…*) for interpretation purposes of the legally defined rules of conduct of the *Investmentgesetz*. Compliance with Part I of the BVI rules is verified by the auditor of the management company/ investment company who has to outline in its report to the regulator whether companies have considered the BVI rules. If an infringement is reported, the BaFin can order a special audit. From July 2011 investors will have access to a great deal of the audit report. Germany is also in the process of implementing the EU UCITS Directive in 2011 (see Section 1.3 above) which requires significant disclosures to the public concerning the use of voting rights and the management of conflicts of interest.

Part I of the BVI code also sets out to limit churning with the object to increase fees (a strong criticism of funds in other jurisdictions) and also specifies some governance arrangements in the voluntary Part II. In particular, the investment company supervisory board should have at least one member independent of the owners of the investment company. While there are other laws specifying fiduciary type duties of the supervisory board members, the requirement of only one independent board member is fairly minimal, especially compared with the SEC (Rule ICA 26520) that effectively requires a 75% majority of independent directors as well as an independent chairman of the board. Moreover, in contrast to German law, audit and nominating committees have to consist entirely of independent directors.

The level of compliance with the voluntary code in the past is not known with any certainty but as noted above Part I is now mandatory. A number of market participants

believe that compliance has been minimal with very few publishing their proxy voting policy and only one having a significant number of independent board members on their supervisory board and thus going beyond Part II of the BVI Code. The code is also less ambitious than another proposed in 2005 (German Working Group, 2005).[5] In sum, Principles II.F.1 and II.F.2 are probably only partially implemented as at mid 2011 but this will change with the implementation of UCITS.

The OECD is aware of only one study about practices of institutional investors: a DSW survey of 2008. However, only 25 fund managers are said to have responded. However, 80% replied that they had fund guidelines which included important corporate governance aspects. Some 40% exercised votes on German shares of 80 to a 100% and a further 40% of between 60-80%. When asked what were the main reasons for the non-execution of votes for German and foreign shares, 50-60% of respondents replied that they did not have enough time, and that costs and administrative efforts were too high. Over half the respondents exercised less than 20% of their foreign voting rights in 2007.

Domestic pension funds are much less developed in Germany than in many other countries since pensions have been met traditionally by the budget on a pay-as-you go basis and by companies setting aside book reserves. However, since 2001 a new funded system of supplementary pensions has been in force. The new pensions accounts are offered by regulated financial institutions such as investment management companies, banks and insurance companies. Insurance company assets are much greater than those for investment funds with classical pension funds quite small.

Although mutual funds predominate there are many different investment strategies ranging from indexed funds to actively managed funds. There are also funds focused on special issues such as the environment and some funds also follow the UN's Principles for Responsible Investment. Cutting across these various investment strategies is the question of investment horizon: being mutual funds, are they more short term than it is alleged is the case with pension funds.[6] The OECD is not in a position to make a judgement on this complex issue since it lacks turnover data which, as discussed in Part 1, is only at best a poor proxy for investment horizon.

Box 4.1. **Voluntary code of conduct of the German Association for Investment and Asset Management**

The voluntary code seeks to establish a governance framework for the industry. As such it deals with issues such as valuation of funds and performance reporting. From the governance perspective, the most important provisions are:

- Part I. When performing its functions, the investment company (KAG) acts exclusively in the interest of the investors and the integrity of the market. This aims at controlling price manipulation and the use of insider information. The principle states that the investment company exercises the shareholder and creditor rights of assets of the individual funds independently of the interests of third parties, including a depositary bank and affiliated enterprises. The independent exercise of voting rights also applies in respect of recommendations made by the investor of a special fund.

Box 4.1. **Voluntary code of conduct of the German Association for Investment and Asset Management** *(cont.)*

- Part I. The investment company endeavours to avoid any conflicts of interest. By implementing appropriate organisational measures, the investment company ensures that risk of conflicts of interest between the company and third parties is kept to a minimum. Potential conflicts of interest include incentive systems for employees, reallocation of investments between funds, transactions between the company and individual funds and frequent trading. The investment company must establish procedures which are suitable to; identify circumstances giving rise to conflicts of interest; and to resolve such conflicts paying due regard to the protection of the interests of the investors and/or investment undertakings. Of particular importance, for the funds managed by a company, there will be suitable procedures to avoid excessive transactions costs as a result of *inter alia*, excessive turnover. Transactions which merely serve to generate additional fees are not permissible.
- Part II. The supervisory board and management of the investment company will work towards good corporate governance on the investment company. The two boards may not pursue their own interests and the supervisory board will ensure that the management have appropriate risk management and control. The supervisory board shall have at least one member who is independent of the owners, their affiliated companies and the business partners of the investment company.

Source: German Association for Investment and Asset Management (BVI), *www.bvi.de, draft translation*

4.3. Exercise of shareholder rights

This section reviews what is known about the actions by institutional investors, both domestic and foreign. The most observable action is voting but this says in itself little about the quality of company monitoring and about direct consultations with companies.

4.1.3. Shareholder rights

The potential role of shareholders and of institutional investors is constrained by corporate law. Indeed, even a controlling shareholder who wants to alter the business model has great difficulty, because they have first to change the SB which then changes the management board. This also makes takeovers very difficult and in some cases several years may be required to exercise control over a target company. There are, however, significant powers for shareholders as a class and a number of key areas where they can make their influence felt in rejecting company actions.

Shareholders have always had strong pre-emption rights but rights in general have been reinforced more recently. A 1998 law implemented the one-share-one vote doctrine and phased out voting caps and shares with multiple voting rights that were previously held by insiders to buttress their control. This was welcomed by institutional investors. The authorities implemented a Ten Step Program during 2003-2005, the core of which were measures to improve the protection of minority shareholders by enhancing transparency and disclosure, limiting the scope for market manipulation and increasing the liability of the management and supervisory boards. Transparency was also aided by the disclosure of substantial voting rights in a more detailed way.

Class actions regarding management liability (*i.e.* claims brought in the name of an unknown group of claimants) are not permitted although there has been some recent easing of the law. Thus the only redress available to shareholders until recently involved derivative law suits, requests for a special audit and requests to the regulator for an investigation. These are all collective rights. A single shareholder cannot file suit in the name of the company, however minorities representing more than 10% of share capital can launch a suit. Special meetings of shareholders can be called by shareowners owning an aggregate of at least 5%. Shareowners with a minimum of 20% or 500 000 euro of nominal share capital can require that items be included in the published meeting agenda. All significant company transactions such as mergers and acquisitions must be approved by at least 75% of those present: 25% represents a blocking minority. Around 80% of German companies have at least one shareholder controlling more than 25%. The German system of shareholder protection puts less emphasis on management liability claims by shareholders and more on contesting decisions of the Annual General meeting. A single shareholder with a single share is able to appeal against an AGM decision in court and can have it stopped. This powerful right has led to some misuse by such shareholders.

A key area of concern for minority shareholders including institutional shareholders is conflict with large shareholders due to self-dealing. According to company law, the control of such transactions is the responsibility of the supervisory board. In the case of companies controlled by another, German company law (*Konzernrecht*) regulates conflicts between minority and large shareholders and requires SB approval for specified self-dealing transactions. However, Baums and Scott (2003) and others question whether SBs have the requisite independence to effectively control self-dealing, especially in the case of dominant owners. Independent SB members comprise only 22% of boards compared with the European average of 43% (Heidrick & Struggles, 2011) Shareholder approval of self-dealing transactions is absent under German law. An annual report detailing such transactions is shared with the SB but is not shared with shareholders.

Institutional shareholders have also expressed concern about the lack of shareholder consent for significant measures such as takeovers, disposals and reorganisations. This has arisen after the co called Gelatine decisions of the high court (Bundegerichthof) that requires a very substantial (say 80%) change in company assets to necessitate shareholder approval. A significant example that was taken up by institutional investors was the 2006 takeover of a large pharma company Schering by Bayer for EUR 17 billion, two thirds of its own market capitalisation. This major strategic change did not require the consent of shareholders.

According to German law, shareholders are to be treated equally under equal circumstances. The courts and jurisprudence have recognised a fiduciary duty of shareholders both *vis-à-vis* the company and between each other to complement the principle of equality. In general terms, under the concept of fiduciary duty, shareholders have to use their ownership rights in such a way that they contribute to the corporate purpose. Indeed, they should refrain from all acts that run contrary to the corporate purpose: they may not use their rights in a way to severely damage the company or jeopardise measures to rescue the company in a severe crisis. Whenever they exercise their individual rights, they may not do so in an arbitrary or disproportionate way and have to take into consideration the rights of other shareholders. The breach of these duties may lead to liability or to the loss of voting rights. This is a potential barrier to more activist investors such as some hedge funds.

The German Corporate Governance code first published in 2002 and last amended in 2010 stresses the need for transparency and clarifies shareholder rights. Moreover, the code's "comply or explain" concept helps to foster transparency by requiring an explanation from those companies not complying with provisions of the code. An important power available to shareholders is the need for the SB and MB to seek a discharge from shareholders for the annual accounts. Dissatisfied shareholders have often sought to raise pressure on the boards by seeking to reject the discharge (see below).

Since 2010 German companies are required to make detailed remuneration disclosures and may propose an advisory vote on remuneration policy at the AGM which ensures full accountability of the supervisory board. Almost all major companies (DAX 30) introduced such votes in 2010 and even went so far as to hold discussions with major institutional shareholders. Some institutional shareholders have said that they would also seek the appropriate quorum to put the item on the agenda as shareholders (Manifest Information Services, 2010).

In sum, shareholder rights that may be of concern to institutional investors differ from those in other countries especially with the small role of the market in corporate control. Whether institutional investors can make use of the existing opportunities will depend in part on limits to co-operation to reach threshold voting levels, discussed below.

4.3.2. Shareholder co-operation

In view of extensive block shareholdings in smaller German companies and the very large size of others, and the need to obtain critical thresholds for certain shareholder rights (see above), it is important for institutional shareholders to be able to co-operate. This has to be done very carefully so as to avoid being judged to be acting in concert that requires a mandatory bid for the company. To indicate what is involved, the recent case of Infineon might be typical. The "initiator" was a foreign fund (Hermes) which wished to initiate action in a company in long term decline by voting against its Chairman. After consulting legal counsel, it avoided contact with other institutional investors but published what it was intending to do in the hope others would join.

Acting in concert has been defined under German law as "co-ordinating conduct on the basis of an agreement or in a similar manner".[7] Sections 30 and 35 of the German Takeover Act (*Wertpapiererwerbs- und Übernahmegesetz*, WpÜG) describe the consequence that a mandatory offer has to be made if the votes of parties acting in concert exceed 30%. Agreements on the exercise of voting rights in individual instances ("*Einzelfälle*") are excluded from the definition.[8] In addition, case law has emerged laying down additional criteria to clarify this legal definition of acting in concert. In a landmark case (Pixelpark Aktiengesellschaft), the Higher Regional Court of Frankfurt held that the serious legal consequences of acting in concert demanded further clarification and developed the following criteria:[9] parties are acting in concert if they co-ordinate their behaviour with the objective to exercise voting rights in a co-ordinated and continuous manner and to exert enduring ("*nachhaltig*") influence. In 2006, the Federal Court of Justice provided for further clarification (Münchener Rückversicherungs-Gesellschaft AG) construing the legal definition of acting in concert narrowly.[10] It held that only co-ordinated behaviour relating to the exercise of voting rights during the AGM can amount to acting in concert. Many activist investors expressed concern about whether co-operation that is allowed in other jurisdictions might nevertheless be interpreted as acting in concert in Germany, and

therefore either be illegal and /or require a mandatory bid for the company, depending on the voting power of the "group".

In response to uncertainties, the German federal government modified the concept of acting in concert with the Risk Limitation Act (*Risikobegrenzungsgesetz*), the voting rights sections of which came into force on 1 March 2009.[11] The law envisages the following definition of acting in concert: concerted actions in a manner suitable to influence the corporate strategy (*i.e.* business model) permanently or substantially. Contrary to what was contemplated in the original draft, shareholders co-ordinating their conduct in individual cases continue to fall outside the scope of acting in concert. Jointly exercising influence on issuers does not per se constitute acting in concert, as long as it is limited to specific individual cases (*Einzelfälle*). Where the parties acting in concert are deemed to hold more than 30% of the voting rights, a mandatory bid offer must be launched. Any party holding over 10% of the voting rights must declare the source of their financing and their intentions with the investment such as whether they intend to influence the appointment of directors and members of the supervisory board.[12] This is similar to the SEC's schedule 13d. Disclosure is also mandatory on voting rights emanating from financial instruments (threshold of 5%). However, scandals relating to Porsche and Schaffler where cash options were used to build up undeclared positions indicate significant loopholes. A suspension of voting rights for six months is required for intentional violations; a lengthy period is foreseen as an enforcement mechanism. The draft bill met with considerable opposition and it remains to be seen whether legal uncertainties will serve to reduce shareholder co-operation. A number certainly remain cautious. In sum, Germany has broadly implemented Principle II.G even though it might be limiting.

4.3.3. Use of proxy advisors

The larger fund management companies and specialised ones that run individual funds have their own resources for monitoring companies. However, they are increasingly using a number of external proxy agents, the largest being ISS with domestic competitors such as IVOX. It is believed that in some cases investors have provided the proxy agents with their own corporate governance guidelines against which to judge recommendations. In response to the OECD questionnaire, the German authorities stated that there are estimates that 80% of foreign institutional investors follow the advice of shareholder service companies. It is not known the extent to which Principle V.F is implemented: *the provision of advice is free from material conflicts of interest that might compromise the integrity of their analysis or advice.*

4.3.4. Dialogue with companies

According to market participants, a number of larger domestic institutional shareholders and some foreign institutions (particularly British, Dutch, and US) are active in meeting company representatives and in explaining their positions. In some cases it is reported that companies have altered their proposed actions. On the other hand, the small study by DSW does indicate that monitoring is costly.

Several German companies have also been active in seeking institutional investors to take a significant shareholding (*e.g.* Daimler). In several cases these are reported to have been from sovereign wealth funds. Little more is known about relations with these investors and indeed whether and how they are active.

4.3.5. *Voting behaviour*

Foreign institutions

Information about voting by foreign institutional investors is not readily available apart that is from controversial cases such as at Deutsche Börse. One study based on a small sample of 14 large shareholder meetings between 2003 and 2005 concluded that, relative to their holdings, their voting propensity was only a very small fraction of voting by domestic entities (as quoted in Zetzsche, 2008). Market participants in Germany believe that turnout by foreigners is quite low relative to their shareholdings and indeed this pattern is repeated in other countries. The DSW study (see above) indicates that German investors are not active in voting their foreign shares.

Domestic voting

Manifest (2011) has undertaken on behalf of the OECD a study of voting at company shareholder meetings. Almost 50% of German companies now disclose details of abstentions, a significant improvement on the prior year. The absence of abstention data in respect of voting at meetings impedes an informed analysis of the true level of dissent, particularly given that the stated policies of some German investor organisations include an escalation strategy which explicitly provides for abstention votes as one of a series of steps that should be used by investors to highlight concerns. Based on Manifest's experience, meeting minutes containing the voting results are often published in German only with no English translation.

4.3.6. *Turnout*

Participation levels at shareholder meetings steadily declined in the early part of this decade, but the introduction of the record date in 2005, as well as other measures to facilitate the exercise of voting rights, has helped contribute to a resurgence in turnout. This increase is believed to be attributable in part to some foreign institutional investors who started voting at German general meetings after the introduction of the record date in Germany in 2005. Foreign ownership in DAX30 companies has breached 50% in recent years and was one reason for the introduction of the record date by the authorities.

Research by Manifest has shown that the number of German fund managers exercising their voting rights on domestic shares has increased dramatically, with the reasons given for the non-execution of votes being high costs/administrative expenses and time pressure.

A significant proportion of German blue-chip companies include large blockholders which boosts average turnout levels. The turnout figures show a reasonably healthy level of participation by shareholders – Germany is a solid "mid table" in terms of global turnout figures, and is towards the stronger turnout levels within Europe.

It is impossible to judge from meeting poll data the degree to which domestic shareholders vote their shares more than foreign shareholders, if at all. It may also be quite impossible for issuers to be able to tell either, due to the lack of transparency of ownership which prevails within and between the various levels of intermediation that exist between owners and issuers especially in the cross-border context. The names that appear on their share register are very different from the actual underlying shareholders.

Improvement to turnout figures may be partly challenged by the legacy of previous practice. Whereas there used to be a perception of Germany being a "blocking market", whereby shares (especially bearer shares) might have been immobilised from trading for a period of time as a part of the process of registering the shares in order to vote them, this is by and large no longer the case. However, misconceptions on this may persist, especially amongst retail investors.

Germany is characterised to an extent by a multitude of small, regionally-based banks many of whom act as intermediaries in the voting process. In the transition towards voting by correspondence or proxy, and away from physical participation in meetings, the demands placed on the role of intermediaries has changed from a relatively passive registration facilitation role towards one of proxy representation in meetings. Some smaller, provincial intermediaries have been slow to respond (or slow to receive sufficient demand to change), meaning some shareholders rightly or wrongly perceive it is not possible to vote.

Table 4.2. **Average shareholder turnout is reasonable**
(April 2009-November 2010)

Event type	Number	Turnout
AGM	134	64.84
Class	2	26.26
EGM	5	71.50
Total	143	64.52

Source: Paul Hewitt (2011) (representing Manifest Information Services), "The Exercise of Shareholder Rights: Country Comparison of Turnout and Dissent", *OECD Corporate Governance Working Papers*, No.3, *www.oecd.org/daf/corporateaffairs/wp*.

Comparing the average turnout for AGMs and EGMs, one must be cautious in making too many generalisations due to the relatively small number of EGMs in the sample. German companies tend to hold back on extra-ordinary meeting business until the next scheduled General Meeting of shareholders. However, the figures do seem to suggest that, in general, EGMs receive a higher turnout. This is not to suggest that it is easier to vote at them, but, due to the extra-ordinary nature of the meeting business decided at the meetings, the cost and difficulty of voting is deemed less problematic by shareholders in the face of the extra-ordinarily important decisions (such as exceptional capital raisings or take-overs). This is borne out by the higher dissent levels for such questions in the section below on management resolutions.

4.3.7. Dissent

Dissent by meeting type

Almost 50% of German companies now disclose details of abstentions, a significant improvement on the prior year. The absence of abstention data in respect of voting at meetings impedes an informed analysis of the true level of dissent, particularly given that the stated policies of German investor organisations include an escalation strategy which explicitly provides for abstention votes as one of a series of steps that should be used by investors to highlight concerns.

Table 4.3. **Shareholder dissent remain low**

Event type	Dissent (%)	Resolutions
AGM	2.95	1 978
Class	17.75	3
EGM	4.45	11
Total	2.98	1 992

Source: Paul Hewitt (2011) (representing Manifest Information Services), "The Exercise of Shareholder Rights: Country Comparison of Turnout and Dissent", *OECD Corporate Governance Working Papers*, No.3, *www.oecd.org/daf/corporateaffairs/wp*.

Dissent on EGM resolutions is slightly higher than for AGM resolutions, if still at a very low average level. This may be explained by the fact that, although such meeting business is by definition unusual (hence not being treated in quite the same "routine" manner as may be the case for AGM resolutions), the expense of holding an EGM in the first place means that business is nevertheless very carefully prepared and choreographed; it stands to reason that management would not call an EGM (as was the case in all 5 in this sample) without being confident that shareholders would approve the business they wish to conduct.

Dissent by resolution type

Manifest analysed average dissent by type of resolution at all of the German meetings for which they obtained poll data. A number of patterns and observations emerge from the data. First, with regard to the number of resolutions of each type there is a clear variety. Perhaps most unusual is the relative lack of Annual Report resolutions. This can be explained by the fact that only KGaA companies (partnerships limited by shares) are required to have a vote on the Report and Accounts. Normal listed companies may present the Report and Accounts without then having a vote.

From an investor perspective, more significant is the "Director's discharge" resolution, whereby the directors are collectively (or, more commonly, individually) discharged from liability in respect of the financial year under review. This helps to explain the fact that the most common type of resolution in Germany concerns "Director's Discharge". The resolution is an indicator of whether the shareholders agree with the work of the directors in general. It does not mean a discharge from any liability claims. It is thus a good means of registering discontent rather than mounting a proxy contest against a sitting member. Table 4.3 indicates that it is used with sometimes very high levels of dissent (*i.e.* considering both the average and a standard deviation of 21%, Table 4.4).

Manifest also analysed the average dissent per resolution type, as well as the standard deviation for each set of dissent figures. The first gives an indication of the relative likelihood that shareholders vote against management on particular types of issue. The standard deviation figure gives an indication of the relative consistency of the level of dissent (the lower the standard deviation, the more consistent shareholders are in showing the indicated average level of dissent. With regard to the average dissent levels for each resolution type, the most conspicuous is shareholder proposals. These are discussed in more detail below.

Unsurprisingly, remuneration related resolutions are the most contentious in German meetings. Amongst these resolutions, the most contentious are consistently resolutions proposing a new remuneration system for the board and frequently for executives. Only

Table 4.4. **Shareholder dissent depends on the type of resolution**

Resolution type	Average dissent (%)	Standard deviation (%)	Number of resolutions
Shareholder	15.92	20.84	23
Remuneration	6.68	11.22	62
Capital	5.40	7.92	326
Director's discharge	3.05	8.63	750
Election	2.38	5.09	254
Other	1.36	1.31	4
Articles	0.82	2.89	250
Dividend	0.77	2.43	119
Agreement	0.56	0.73	53
Auditors	0.50	1.54	143
Annual Report	0.19	0.30	7
Grand total	**2.98**		**1 992**

Source: Paul Hewitt (2011) (representing Manifest Information Services), "The Exercise of Shareholder Rights: Country Comparison of Turnout and Dissent", *OECD Corporate Governance Working Papers*, No. 3, *www.oecd.org/daf/corporateaffairs/wp*.

one resolution in this category was defeated, that of Heidelberg Cement AG whose proposal to approve the remuneration system for the management board members at their AGM in May 2010 was defeated with an "Against" vote of 54%.

Remuneration resolutions are also those on which there is most variety in the level of approval (highest standard deviation). This would suggest that shareholders have reason to be and are more vocal on remuneration issues.

Whilst less contentious than remuneration resolutions in terms of average dissent, capital resolutions also had a comparatively high level of dissent and standard deviation compared to most resolutions. By definition these issues are highly company and investor specific, touching as they do on the strategic considerations as to how the company's finance and ownership is structured, which explains the standard deviation levels.

Director's discharge resolutions are the most numerous in the sample, and show an interesting trend in that when shareholders are asked to review and approve the past acts of board members at an individual level (effectively the consideration for individual discharge resolutions), they are more critical than when evaluating the future prospects of board members as represented by their voting on director (re-) elections.

The high standard deviation levels for director discharge levels also seems to suggest that, alongside remuneration, this type of resolution is the one on which shareholders are most vocal and consider most on a case by case basis, because of the variety with which they respond to such resolutions. This might be summarised by saying that shareholders in German companies are at their most critical when approving the acts of specific directors in the past and when evaluating the reward structures under which they will operate in future.

Shareholder resolutions are quite prevalent in Germany because of the practice of counter-proposals. Any shareholder may submit counter proposals within one week of the publication of the meeting notice in the Bundesanzeiger. However, the actual counter proposals are not published in the Bundesanzeiger but are published on the website of the Company. It is typical for voting on the board proposal to be taken first, with the counter proposal only presented to the meeting if the board proposal is defeated.

The majority of the counter proposals are published in German language only and are not accompanied by an English translation, which can hinder the decision making process of foreign investors. Those counterproposals which merely reject proposals by the management and supervisory boards do not appear on the proxy form. If shareholders wish to vote for these counterproposals they must vote against the respective item on the agenda.

Some companies identify those counter proposals which not only reject the Board proposal but put forward a concrete alternative proposal. These counterproposals may appear on the proxy form, however they are not always actually voted upon at the meeting.

Although many counter proposals relate to trivial matters or personal grievances, the counter-proposal mechanism does offer some benefits and has been used by institutional investors in the past to express concern. Most recently it has been used at Infineon in a dispute over the election of the chair of the Supervisory Board. Counter-motions when used by institutional investors are seen as an expression of discontent that ranks higher than votes against management proposals. Given their varied nature, it is not surprising that shareholder resolutions also display a high level of standard deviation.

4.3.8. Major shareholder voting

The importance of understanding who are the major shareholders in a company is underlined by the fact that they must be reported to the market. This is done at the time the major shareholding is established or changes.

However, in the context of meeting results analysis where the holding on a specific date is key, the publicly available information may not be sufficiently accurate. Companies disclose in their annual report the major shareholders, either as at the financial year end, or as at some other date subsequent to the year-end but (obviously) prior to the publication of the annual report and accounts. This lack of consistency of reported data hinders meaningful analysis.

Additionally, given that the annual report is subject to approval at an AGM, major shareholders disclosure becomes a part of the meeting materials and, by definition, is therefore around two months out of date by the time of the meeting to which it is purported to relate.

In the absence of the ability to obtain detailed meeting-date share register analysis from publicly available information, the typical role of major shareholders at corporate meetings is technically impossible to quantify, though the poll results of some meetings may offer convincing circumstantial evidence, especially where a major shareholder is a majority shareholder.

Analysis of German companies and the role of major shareholders is therefore made very difficult without specific additional disclosure as to how major shareholders have voted. Disclosure of this kind is, in turn, made very difficult by the lack of transparency with regard to ownership through a chain of financial intermediaries to the ultimate or beneficial owner.

4.4. Conclusions

In sum, Germany has an important domestic institutional shareholder base as well as a significant presence of foreign institutions, especially in large companies. Domestic fund managers appear to have become much more active over the past decade at least in terms

of voting at shareholder meetings. Moving to a record date for eligibility in 2005 has certainly underpinned this development and has also stimulated foreign investors. There have also been a number of occasions when domestic institutional investors have shown their displeasure with actions being carried out by companies. In the past, such investors would have been more passive but now it has extended to the first proxy fight over the supervisory board, rejected agenda items and counter-motions that have been carried at certain companies (*e.g.* Heidelberg Cement, Infineon and Siemens). Activist hedge funds are also active under certain circumstances such as at Porsche and VW.

Nevertheless, it is difficult to form conclusions about the effectiveness and extent of such engagement since little information is available from fund management companies about compliance with the BVI voluntary code of behaviour. The code is minimal with respect to corporate governance arrangements of investment companies but it is now mandatory in other areas such as engagement, transparency and avoiding excessive churning of shares. The Code covers the basic elements of Principles II.F.1 and II.F.2 and with the implementation of the UCITS Directive in 2011 Germany should have fully implemented these principles. This is important since the potential for conflicts of interest is present given the ownership of investment companies by banks and insurance companies.

The governance of fund management companies also needs further attention. The recommendation of the BVI Code that there be only one member of the supervisory board independent of controlling shareholders is not sufficient in Germany given the extensive ownership of institutional investors by banks and insurance companies. Strengthening the supervisory board should also require an independent audit committee.

The most concerning gap in the institutional structure concerns the engagement with foreign investments. There are two sides of this. German funds now have significant investments abroad but their voting behaviour is minimal and other engagement activities possibly even less. There are of course difficult issues concerning cross border voting and costs that still need to be resolved including record dates too far in advance of a shareholders meeting. Nevertheless, other measures might still be needed such as a revised code of conduct requiring them to vote on their significant foreign investments. On the other hand, foreign investors are now a significant force in Germany but all the evidence points to reduced voting behaviour and engagement in comparison with domestic investors, apart from one or two exceptions. Although this is a more general issue in the global economy, the German authorities should examine what potential domestic policy options are available. Among these it would be important to move to simplify further the voting chain, even though a lot has already been achieved (*e.g.* electronic voting, proxies).

In view of the institutional structure of Germany, proxy advisors are thought to play a significant role. It is believed that some investors request the proxy advisors to use the investor's corporate governance standards rather than their own. Whether conflicts of interest have been resolved (Principle V.F) remains unclear.

The rules governing co-operation between investors have been clarified since 2009 but still remain potentially restrictive. This is because they seek to prevent investors from seeking to "influence a company's strategic orientation in a permanent and strategic manner". This is understandable in Germany since company law assigns responsibility for strategy to the management with significant input by Works Councils in a consensual

process. However, it does mean that investors must present their views in a highly personalised manner to avoid discussing strategy which is really their concern. This serves to reduce market transparency.

Notes

1. Defined as total shareholding minus holdings of over 5%, government holdings and those known shareholder agreements extending beyond six months.
2. Poison pills involving the issue of stock at a deep discount are illegal since they contravene strong pre-emption rights in company law.
3. Managers in most continental countries and Japan also favour a stakeholder perception and place a strong emphasis on job security. Dividends are nevertheless important with the notable exception of Japan where job security dominates corporate objectives (Odenius, 2008).
4. In particular, if banks want to exercise the proxies, they have to publish proposals for voting before the meeting, and vote this way, if the respective shareholder has not issued other instructions and; shareholders may issue general instructions to the bank to vote as proposed by the managing board and the supervisory board (D. Bohn *et al*., 2009).
5. Under the proposed code, management companies were recommended to publish their own guidelines on corporate governance policy (including conduct for the exercise of voting rights), rules for share voting and any deviations from the code. In addition, a shareholder protection association (Deutsche Schutzvereinigung für Wertpapierbesitz, DSW) developed ten principles in 2002 covering investment funds.
6. In countries such as the Netherlands and Australia, pension funds outsource fund management to investment managers, so that the general term pensions does not convey much information about strategies.
7. Section 30, Para. 2 of the German Takeover Act and Section 22, Para. 2 of the German Securities Trading Law (Wertpapierhandelsgesetz, WpHG).
8. Section 30, Para. 2 of the German Takeover Act.
9. OLG Frankfurt, 20th Zivilsenat, 25 June 2004, ref. No. WpUeG 5/03, WpUeG 6/03, WpUeG 8/03.
10. BGH, 2nd Zivilsenat, 18 September 2006, ref. No. Az. II ZR 137/05.
11. For an English language discussion of the law see J. Perlitt *et al*., 2008, "German risk Limitation Act Provide for investor Transparency and Protection of borrowers", Euro Watch, 15 September.
12. This is also the case in Korea and is similar to declarations under Schedule 13D in the US. In Korea, changes were introduced following the activities in the Korean market of an activist investor (Sovereign). See *OECD Economic Survey of Korea*, 2007. In Japan, there has also been concern to declare the "beneficial investors" if an investment fund is involved. The proposed German law also covers beneficial ownership which would be disclosed to the management board but not to shareholders.

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ANNEX A

The Questionnaire of the OECD Corporate Governance Committee

INSTITUTIONAL INVESTORS AND KEY OWNERSHIP FUNCTIONS

Objective

At its meeting on 16-17 November 2010, the OECD Corporate Governance Committee agreed to carry out a thematic peer review on the exercise of ownership rights by institutional investors. The scope of the exercise is presented in the scoping paper DAF/CA/CG(2010)12, which is annexed in this questionnaire. The review will focus on the implementation of Principle II.F, which addresses the need for institutional investors acting in a fiduciary capacity to disclose their overall corporate governance policies; their procedures for using their voting rights, and; how they manage of conflicts of interest, and Principle II.G, which addresses the right for shareholders to consult with each other. Beyond a review of the implementation of Principles II.F and II.G, the review shall aim at a better understanding of factors that determine to what extent institutional investors make use of their ownership rights and what differences may exist between different categories of institutional investors in this respect. Finally, the exercise shall review the existence and experiences with any statutory regulation or voluntary codes that address the exercise of ownership rights by institutional investors.

How to complete the Questionnaire?

The questionnaire has two parts. Part one shall be completed by all countries, while part two shall be completed only by those three countries that are subject to an in-depth review. For other countries, part two is voluntary.

Those members only replying to the first section should point the Secretariat to the main features of the relevant corporate governance framework and existing studies, if available. It is not expected that replies should be long and detailed. For example, we do not expect full translations of legal documents as required for FSAP and FATF reviews. We are only interested in relevant parts.

For those 3 countries that participate in the in-depth review, (and others which wish to also participate on a more detailed level), it is suggested that a response to Questions II and III might be around 3-5 pages each. In preparing the responses, delegates may want to emphasize differences within classes of institutional investors, their governance structures, incentives and performance. For that, it is suggested that the securities and sectoral regulators may be consulted, as well as any code oversight or professional bodies (directors' institutes and investor bodies) that have responsibility over institutional investor behaviour. Academic, research and corporate governance organisations might also be appropriate sources of information.

PART 1

To be completed by all countries

For the purpose of this review, we are going to consider that institutional investors includes pension funds, insurance companies, mutual funds, and trusts, together with any agents appointed to act on behalf of investors such as asset managers. They are collectively termed "institutional investors" in this questionnaire. This definition thus goes further than the institutional investor definition used in the Principles which is confined to those institutions acting in a "fiduciary capacity" regardless of investment strategy. This is in line with the Conclusions paper that argued for a widening of the definition and at the same time recognising the need to look at the behaviour of other institutions active in the capital markets. If in your respective jurisdiction there is another important category, please also include it. Please also provide, if available, information on sub-categories (like privately-owned or state-controlled, local or foreign, life insurance *versus* non-life, etc.).

1.1. In your jurisdiction, are institutional investors required to disclose their overall corporate governance policies with respect to their investments? If yes, please describe the legal status of this requirement, how the requirement is formulated and where it can be retrieved.

1.2. In your jurisdiction, are institutional investors required to disclose their overall voting policies with respect to their investments, including the procedures that they have in place for deciding on the use of their voting rights? If yes, please describe the legal status of this requirement, how the requirement is formulated and where it can be retrieved.

1.3. What percentage of the shares of listed companies in your country is typically voted at their annual meeting? If available, please provide statistics in terms of averages or verified estimates. To what extent do institutional investors in your country use their voting rights? If available, please provide any statistics or verified estimates. If the statistics are not self-explanatory, please indicate if there are major differences in voting participation between different categories of institutional investors?

1.4. In your jurisdiction, are institutional investors required to disclose how they manage material conflicts of interest that may affect the exercise of key ownership rights regarding their investments? If yes, please describe the legal status of this requirement, how the requirement is formulated and where it can be retrieved. What is known about the major conflicts of interest such as ownership by other corporate entities?

1.5. In your jurisdiction, are institutional investors allowed to consult each other on issues concerning their basic shareholder rights as defined in the Principles, subject to exceptions to prevent abuse? What is the nature of these exceptions? What restrictions are imposed, what is the legal status of these restrictions?[1]

1.6. Please explain how in your jurisdiction the duties and responsibilities of different institutions are defined. Is there a general concept of fiduciary duty? Please provide reference to the relevant rules.

1.7. In your jurisdiction, is there statutory regulation, voluntary codes or other instruments that mandate or encourage the exercise of ownership rights as a duty by institutional investors (*e.g.* a code of behaviour covering investors)? If there are, please describe them and provide references. What are the experiences with such rules, codes or guidelines? Please provide references to any studies concerning the exercise of shareholder rights in your jurisdiction.[2]

1.8. Please complete as far as possible the attached table concerning assets under administration and the distribution of equity holdings (both foreign and domestic) among different categories of shareholders.[3]

PART 2

To be completed by Australia, Germany and Chile (by others on a voluntary basis)

Where other jurisdictions have information to hand through, for example, specific studies, it would be very useful to provide them to the Secretariat and also if they wish to respond to the following questions. The Secretariat will follow up on the responses from each economy being reviewed by short visits or conference calls, if necessary.

2. What is your evaluation of the role that institutional investors play in your jurisdiction in terms of their engagement as shareholders? Does their engagement go beyond voting? Does their voting behaviour focus on certain specific issues only? Is there a national concept of what is regarded as a responsible investor? Are their differences in the behaviour of foreign and domestic institutional investors? In case your evaluation is that they are engaged enough, please provide examples. In case your evaluation is that they do not engaged enough, could you please elaborate on the possible causes (like the existence of practical barriers, legal restrictions or simply issues related to their business model and corporate governance arrangements, for instance). In such a case, have you done or are you planning to do something to address those factors or influence their incentives to become more engaged? If yes, please describe the policy measures, their rationale and their expected (or already obtained) results.

3. What is your view about the time horizon of institutional investors such as whether they are "excessively short term"? What issues are thought to arise from index tracking business models? What potential issues arise with Exchange Traded Funds? Could they lead to a decline in company monitoring?

The completed questionnaire should be returned to the Secretariat (Hector.Lehuede @oecd.org and Kenji.Hoki@oecd.org with Ruth.Fishwick@oecd.org on copy) by the 14 February 2011.

Any questions of procedure or content should be addressed to Grant.Kirkpatrick@oecd.org and Hector.Lehuede@oecd.org with Ruth.Fishwick@oecd.org on copy.

Notes

1. This question is aiming to review the extent to which jurisdictions have been able to clarify the scope of "concert party" rules in order to facilitate investor co-operation on corporate governance matters.
2. The purpose of this question is to review how and to what extent industry codes of best practice on "stewardship" are being used to promote more active engagement, and the experiences that regulator, industry bodies and investors have with such measures.
3. The purpose of this question is to obtain a proper understanding of the institutional shareholder base, including characteristics such as concentration and time horizon. Understanding the relative importance of different investor classes in particular markets will help determine the extent to which policy responses are likely to be effective.

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ANNEX B

The Data Requested in the Questionnaire of the OECD Corporate Governance Committee

Year		2009				1999				1989			
		AUM (local currency)	AUM (USD)	% allocation to equity	% ownership structure	AUM (local currency)	AUM (USD)	% allocation to equity	% ownership structure	AUM (local currency)	AUM (USD)	% allocation to equity	% ownership structure
Institutional asset owners	Domestic												
	Pension funds												
	Insurance companies												
	Mutual funds												
	Other institutional asset owners												
	Foreign												
	Pension funds												
	Insurance companies												
	Mutual funds												
	Other institutional asset owners												
Financial sector	Banks												
	Other financial institutions												
Non-financial sector	Non-financial enterprises												
	Individuals												
	Public sector												
	Others												
Total					100%				100%				100%

Controlling shareholders													
Block shareholders													
Minority shareholders													
Total					100%				100%				100%

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Corporate Governance

The Role of Institutional Investors in Promoting Good Corporate Governance

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