Corporate Governance Forum

Corporate Governance in Today's Equity Markets and the Role of Institutional Investors – A Public Policy Perspective

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Mats Isaksson and Serdar Çelik

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Mats Isaksson and Serdar Çelik
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Preface

This volume of the Corporate Governance Forum printing series contains two reports by Mats Isaksson, Head of the Corporate Affairs Division at OECD, and Serdar Çelik, Senior Economist, namely *Who Cares? Corporate Governance in Today's Equity Markets*, and *Institutional Investors as Owners: Who are they and what do they do?*

The reports have also been published in the OECD Corporate Governance Working Papers series, and are available in original form under the following references:

> Isaksson, M. and S. Çelik (2013), "Who Cares? Corporate Governance in Today's Equity Markets", OECD Corporate Governance Working Papers, No. 8, OECD Publishing, Paris, available at: http://dx.doi.org/10.1787/5k47zw5kdnmp-en

> Çelik, S. and M. Isaksson (2013), "Institutional Investors as Owners: Who Are They and What Do They Do?", OECD Corporate Governance Working Papers, No. 11, OECD Publishing, Paris, available at: http://dx.doi.org/10.1787/5k3v1dvmfk42-en

We at Corporate Governance Forum are delighted to present this reprinted version with a new introduction by the authors. We are glad to have supported this work by the OECD and we would like to express our sincere gratitude to the OECD for granting us the permission to add the reports to our printing series.

At the time of writing this preface, one of the most discussed corporate governance themes, at least in Sweden, is the public policy intervention initiative in the ownership engagement of institutional investors in publicly listed companies through the newly revised EU Shareholder Rights Directive (2017/828). Among other things, the discussion touches upon whether the directive will be effective in making institutional investors engage in corporate governance, and

whether ownership engagement is at all compatible with the business models of institutional investors.

We are, therefore, especially grateful to be able to publish Mats Isaksson's and Serdar Çelik's reports at this time. The first of the reports (*Who Cares? Corporate Governance in Today's Equity Markets*) provides several highly valuable insights into public policy intervention in matters of corporate governance, as well as empirical knowledge regarding the companies that the corporate governance policies seek to regulate. The second report (*Institutional Investors as Owners: Who are they and what do they do?*) in turn offers insights into the possibilities for engagement in matters of corporate governance by institutional investors, as well as an analytical framework through which the institutional investors engagement can be subjected to further studies. Through this reprint, we hope to aid in the dissemination of the reports, and to expand the discussion regarding policy intervention when it comes to shareholder engagement of institutional investors in the Swedish context.

Rolf Skog

Foreword by Mats Isaksson and Serdar Çelik

Corporate governance is not an end in itself. It is a means to support dynamics in the business sector, productive investments and economic growth. The public policy task is to make sure that the savings of ordinary people are effectively channelled into future oriented investments in the real sector. Investments that will pay for our pensions and create good jobs for future generations.

For this this to happen, corporate governance rules and regulations can never be designed in a vacuum. On the contrary, they have to be developed with a close view to the economic reality in which they will be implemented. This is particularly important today, when we experience important changes in the way that capital markets function and corporations operate.

Against this background, the OECD embarked on an ambitious research programme under the heading *Corporate Governance, Value Creation and Growth*. Using firm- and deal-level data, the project provided an up-to-date description of the various elements of today's capital markets and analysed the possible implications for how we should think about corporate governance. The findings were of direct use during the drafting of the *G20/OECD Principles of Corporate Governance* that were endorsed by the G20 Leaders in 2015.

This volume includes two of the reports.[1] The first report, *Who Cares? Corporate Governance in Today's Equity Markets* is focused on the users of public equity markets. It describes historical trends of how corporations access public equity markets. For several advanced economies, it reveals a long-term decline in both the number of initial public offerings and the amount of money that is raised. The report also discusses developments in the structure and functioning

[1] Other reports published as part of the programme are "Corporate Bonds, Bondholders and Corporate Governance", "Changing Business Models of Stock Exchanges and Stock Market Fragmentation" and "Growth Companies, Access to Capital Markets and Corporate Governance".

of secondary markets and developments with respect to shareholder monitoring and engagement.

The analysis of shareholder monitoring and engagement is further developed in the second report, *Institutional Investors as Owners: Who are they and what do they do?* The report argues that the degree of ownership engagement among institutional investors is highly dependent on their business model. For some institutions, like certain hedge funds, active ownership engagement may indeed be a vital part of their business model. But for the rapidly growing group of indexed passive funds, active ownership engagement in individual companies really has no place in the business model. For them, it is more of an unnecessary cost that should be avoided or minimised. Based on this analysis, it is suggested that if shareholder engagement is not part of an institutions business model and investment strategy, mandatory voting requirements will be ineffective and perhaps lead to counterproductive box-ticking.

We would like to thank the Karl-Adam Bonnier Foundation whose financial support has contributed to the development of this work.

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Who Cares?

Corporate Governance in Today's Equity Markets

*Mats Isaksson and Serdar Çelik**

Introduction

Corporate governance is not carried out in a vacuum. The incentives and abilities of owners, intermediaries, board members, managers and stakeholders depend on the environment in which they and corporations operate. Of particular importance is the functioning of the equity market, which is the place where cash flow rights and voting rights in the form of corporate shares are acquired. As equity markets change in terms of structure, participants, investment strategies and trading practices, so do the conditions for exercising corporate governance. To be effective, policy makers need to recognise these changes, consider their impact and understand their consequences for the design of rules and regulations.

To inform policy making, this report maps and describes the key changes in equity markets over the last decade or so which may affect the conditions for corporate governance. It also provides a brief overview of related policy discussions and select national initiatives that have been taken as a response to equity market developments.

The report starts with a description of the link between corporate governance, value creation and growth. It concludes that the quality

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

of corporate governance plays a critical role at every stage of the investment process, including corporate access to equity, the allocation of equity among competing ends, and the continuous monitoring of corporate practices and performance. It also describes the unique characteristics of equity as risk capital and its role in financing genuine value creation in the form of innovation and long-term growth.

The remainder of the report is structured in accordance with the three main elements of the investment process: access to capital, allocation of capital and the monitoring of capital.

Part II provides an overview of developments in primary equity markets since the early 1990s. Sections 2.1-2.5 focus on initial public offerings in different markets and the share of global equity capital raised by companies from OECD and non-OECD countries. Section 2.6 provides data on secondary offerings and Section 2.7 deals with delistings and share buybacks. Section 2.8 explains recent trends in primary equity markets divided into factors that may influence the supply of equity, the demand for equity and any structural or cyclical variations in initial public offerings. Section 2.9 presents some examples of policy responses to the so-called "IPO crisis".

Part III addresses the issue of efficient allocation. It begins with an overview of the relative size of different categories of owners and a discussion about how their different business models and investment practices may influence their incentives and ability to carry out long-term corporate governance functions. Section 3.2 provides an overview of the key changes in the functioning of equity markets, such as market fragmentation, high-frequency trading and exchange-traded funds. Section 3.3 offers an inventory of corporate governance-related issues of policy reactions with respect to developments in terms of equity market structures and trading practices.

Part IV describes developments with respect to various means of shareholder participation in the corporate decision-making process and gives some empirical evidence of how and to what extent shareholders participate in the decision-making process of the corporation. It discusses the emergence of new categories of investors: how they exercise their shareholder functions and how their actions relate to the objectives of the ultimate beneficiaries.

1. Corporate Governance and Public Policy

While corporate governance is a hot policy topic, little attention has been given to formulating the appropriate role that public policy plays in it. Why does public policy matter and what is it expected to achieve? Without a coherent answer to these questions, any interventions made by policy makers risk being random and even contradictory. A second prerequisite for effective policy is a proper understanding of the reality in which rules and regulations are to be implemented. Who are the actors that will use the rules, what are their incentives and how do they interact? Both corporations and investors come in many different shapes and forms. Without knowledge about their relative significance and the nature of their businesses, regulation will be ineffective and most probably tainted by costly unintended consequences.

This report is an attempt to address both the question of why public policy matters and the nature of the economic context in which these policies are supposed to work today. The report is not a catalogue of reform proposals. In our view, proposals for reform can only come once we have answers to these fundamental questions and have understood their implications. This report will shed some light on that.

Among other things, we document a dramatic shift in listings from developed to emerging markets, which means that concentrated ownership at company level has become the dominant form of ownership in listed companies worldwide. We also discuss whether the lack of new listings in developed markets is related to excessive regulatory burdens or unintended consequences of a decade of profound stock market deregulation. Importantly, our discussion about listings also illustrates that corporate governance rules and regulations do not only concern companies that are already listed. From a dynamic perspective, it is equally important to assess the implications for today's unlisted growth companies – which seldom participate in the public debate – that may, in the future, require access to public equity markets for growth and job creation. We also document how the lengthened and ever more complex chain of intermediaries between savers and companies may influence the efficiency of capital allocation and the willingness of investors to take an active long-term interest in the companies that they own. We also examine how regulatory initiatives to increase shareholder

engagement may have unintended consequences and note that the diversity and complexity of the investment chain can render general policies or regulation ineffective.

While this report covers a lot of ground, developments over the last decade have been so profound that for some issues we have only provided a snapshot of the emerging problems and challenges. As a consequence, the report calls for additional research and analysis of developments that may affect the conditions for access, allocation and monitoring of equity, which is so important for value creation and sustainable economic growth.

1.1 The rationale for public policy

The corporate governance discussion usually takes place on two different levels. One is concerned with the everyday workings of individual companies: how they organise their internal proceedings and build their corporate culture. Much of this is unique to the company in question. The choices to be made are often a matter of business judgement and are seldom in a domain where policy makers and regulators have any specific expertise. The other level of corporate governance is concerned with the overall functioning of the business sector, particularly those corporations that have (or potentially will have) their shares listed on the stock market. At this level, the main concern is to provide corporations and investors with a legal and regulatory framework that maximises their contribution to overarching societal goals.

It is this second level of objectives that underpins the *OECD Principles of Corporate Governance*. The very first principle says that "*The corporate governance framework should be developed with a view to its impact on overall economic performance…*" and that "*…policy makers should remain focused on ultimate economic outcomes…*".

The rationale for this economic approach is that corporate governance policies, laws and regulations influence capital formation and capital allocation, which in turn determines economic growth. Corporate governance rules and regulations determine the conditions under which corporations are allowed to access public equity markets and the terms on which savers are able to invest and participate in the value-creating process of the corporation. So, getting the corporate governance rules right is of fundamental importance

to the functioning of a dynamic private sector. As such, the quality of the corporate governance framework forms part of an economy's competitive edge. But, as illustrated below, the challenges in terms of efficient policy design manifest themselves at every stage of the investment process (Isaksson, 2004).

1.2 Corporate governance, investment and economic growth

The first stage of the investment process is the ability and willingness of savers to invest in equity: to provide entrepreneurs and growth companies with risk capital that they can use for innovation, job creation and growth. A number of provisions are required for savers to come forward, such as a secure means of registration, the transferability of shares, the right to receive corporate information and assurances that the contractual rights that come with the ownership of equity are well defined and enforceable. From the entrepreneur's perspective, this requires a regulatory environment that makes it attractive for the founder of the company to open up and share ownership with outsiders. Considering the great variety of savers and companies, successful matching between the two requires, almost by definition, a certain degree of enabling legislation and contractual freedom.

The second stage of the investment process is about effective allocation. It is not just the total amount of capital that is important to economic growth. It is equally important that the capital is allocated to its best possible use. Here, the efficiency of the equity market depends on the willingness and ability of shareholders to identify the full long-term economic potential of corporate activities. This requires that shareholders have access to all available information about the company. But it is not enough that all shareholders act on the same information. It is also essential that individual shareholders have incentives to independently gather and evaluate unique information about corporate prospects. To ensure this, the corporate governance framework contains a range of different provisions, including disclosure requirements and procedures related to changes in corporate control.

In the final stage of the investment process, corporate governance rules enable shareholders to monitor boards and manag-

ers that exercise the daily use of the money that the shareholders have invested. For this purpose, the corporate governance framework identifies a broad range of means for shareholder voice and a number of different issues on which they can express their opinion, including board composition, remuneration practices and relations with stakeholders.

Considering the fundamental importance of investment for sustainable growth and the pivotal role of corporate governance in this process, the remainder of this report has been structured to explore the relevance of corporate governance at each of the three phases of the investment chain, namely *access* to capital, *allocation* of capital and the *monitoring* of capital employed in individual companies.

1.3 The unique role of equity

The economic importance of corporate governance rules and regulations is intimately (but not exclusively) linked to the unique role of equity financing in society. Since equity capital only has a residual claim on corporate earnings, it can be used to finance projects with uncertain and long-term returns, such as research, product development, innovation or the opening of new markets. These characteristics make equity unique and the only standardised financial instrument dedicated to finance genuine innovation and value creation, which is associated with (Knightian) uncertainty and the very basis for economic progress (Knight, 1921). Moreover, the transferability of shares in the public equity market allows for an important separation between the investment horizon of an individual saver and the investment horizon of the corporation. This means that a promising research project or product innovation does not have to be aborted because one of the shareholders is in immediate need of cash.

As in any other market, the market for equity is expected to function in a way that provides the most efficient means to match supply and demand. In this case, it is the supply of capital from savers and the demand for equity among founders, entrepreneurs and already established companies with growth opportunities. For savers, the market should provide a cost-effective way to identify and allocate funds to those companies they believe have the best business opportunities. When the company does well, the savers should do well. If the market provides this direct relationship between corporate

performance and the saver's income, it also provides the critical incentive in society for savers to scrutinise corporate prospects and allocate capital efficiently among competing ends.

Partly to compensate for the lack of fixed claims on corporate earnings (which is awarded, for example, to creditors and suppliers), the equity holder is granted a set of rights. These rights not only serve as a safeguard against abuse, they also provide the opportunity to proactively influence the direction of corporate activities. As mentioned above, an active and informed use of these rights plays a pivotal role for generating the kind of new knowledge and innovation on which economics depends. When there is a direct relationship between the long-term performance of the company and the prosperity of the shareholder, the long-term interest of the company will also be the interest of the shareholder, particularly since secondary equity markets allow shareholders to sell their claims on all future residual company earnings to another investor. An important part of our inquiry is what happens when this link is broken, and we have to ask ourselves – who cares?

2. Access to Capital and Primary Equity Markets

One of the best established economic relationships is between capital formation, productivity and economic growth.[1] An economy's capacity to continuously invest in new and better means of production is the basis for improving the lives of its citizens and making better use of scarce resources. There are many different sources for financing capital formation, but as described in Part I, the unique ability of equity capital to assume residual risk and handle uncertainty gives it a special role in funding those new and innovative business ventures that have an uncertain outcome and form the very basis for economic progress.

[1] While separating and accounting for the different factors behind economic growth is complex, Jorgenson *et al*. (1987) claim that between 1948 and 1979, capital formation accounted for 46% of the economic growth in the United States. Labour growth accounted for 31% and technical progress accounted for 24%.

Ensuring that companies have access to equity capital is therefore a central policy priority and the rationale for many of the regulatory provisions that are recommended in the *OECD Principles of Corporate Governance*.

Against this background, this part provides an overview of developments in primary public equity markets since the early 1990s. It tracks the amount of equity capital provided in different markets and the share of capital raised by non-financial companies from OECD countries and non-OECD countries through initial as well as secondary offerings. It also contains an inventory of explanations for the decline in initial public offerings (IPOs), the shift in global equity markets and related policy issues.

2.1 Primary equity markets in OECD countries

Figure 2.1 shows the long-term development of IPOs across the OECD, tracking both the total *number* of offerings each year and the *amount* of equity that companies raised from them.

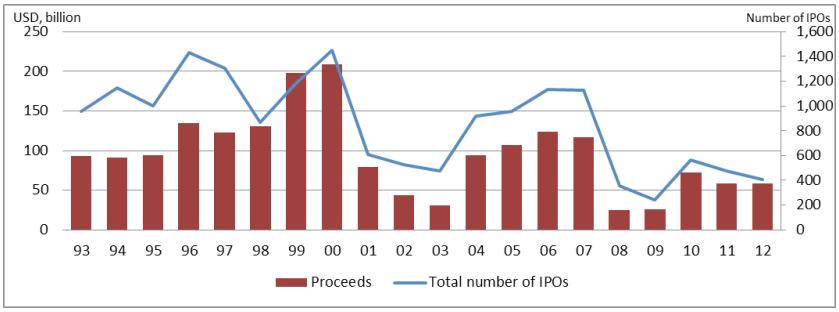
In terms of the number of IPOs, the data suggest a downward trend that began as early as 2000. A period of "recovery" can be noted in the years leading up to the 2008 financial crisis, followed by a sharp decrease in the number of new companies raising capital in the public equity market.

Comparing the two decades reveals that during the period 1993-2000, the OECD annual average was about 1 170 IPOs. During 2001-2012, this number fell to about 650. It is worth noting that even during the "recovery" period before the financial crisis, the annual number of IPOs never reached the average number of IPOs during the 1990s.

The decrease in the number of new firms listing in OECD markets has been accompanied by a decrease in the *amount* of equity that companies have raised in OECD markets. The total value of capital raised decreased from an annual average of USD 134.3 billion between 1993 and 2000 to an annual average of USD 69.8 billion during the period 2001-2012.

Figure 2.1. Primary equity market trends in OECD countries

Number of initial public offerings in OECD markets and the total amount of equity raised (2012 USD, billions)



Source: based on data from Thomson Reuters *New Issues Database*, Datastream, stock exchanges' and companies' websites.

Box 2.1. Methodology

The analysis in Part II is based on original OECD calculations using data from the Thomson Reuters *New Issues Database*. Information from Datastream as well as individual stock exchanges' and companies' websites have been used for complimentary data and validation. The *New Issues Database* provides information on each initial public offering transaction, including proceeds, nationality and sector of the corporation. It also provides information about the market where the IPO takes place.

Between January 1990 and December 2012, excluding the investment funds, Real Estate Investment Trusts (REITs), banks, insurance companies and other financial sector corporations and OTC markets, a total of 36 238 IPOs were recorded. However, the Thomson Reuters database records some IPOs on multiple lines, especially those which have more than one tranche. After eliminating double counting and consolidating these transactions (5 976) and after removing IPOs for which there was insufficient information (41), a final database was established, which contains 30 221 IPOs by non-financial firms from 87 different countries.

In order to avoid a double counting problem, which is a commonly observed one in IPO research, the global IPO proceeds (IPOs in more than one market in a short period of time) have been allocated to the respective markets; REITs and investment funds and listings without additional capital raising have been excluded. The IPOs of companies that were listed in an organised market after the initial offering but currently traded in OTC markets are included.

Secondary public offerings (SPO) data is based on OECD original calculations of data from the Thomson Reuters *New Issues Database* and do not cover financial corporations and investment funds. The definition of SPO covers all share issues of listed companies after an initial offer. After eliminating duplications and removing SPOs without sufficient information, the final SPO database covers 74 015 secondary public offerings during the 1993-2011 period.

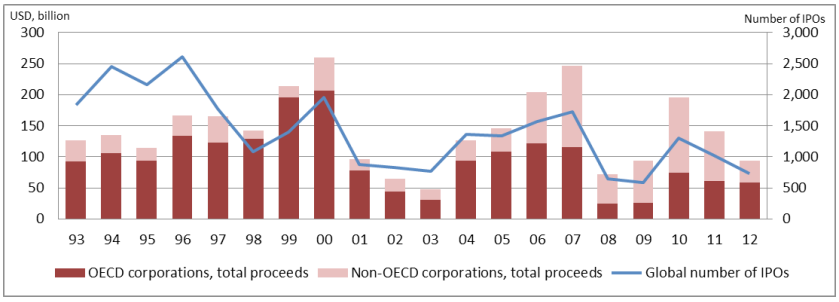
2.2 Global primary equity markets

Figure 2.2 widens the perspective and looks at the total amount of equity raised globally. It also identifies the origin of the companies raising the equity. Figure 2.2 shows that throughout the 1990s, companies from OECD countries dominated the global IPO scene by receiving about 82% of all of the risk capital that was raised in public equity markets worldwide. This dominance ended quite dramatically by the turn of the century, when the absolute amount of capital raised by OECD companies was cut in half compared with the annual average of the previous decade. This resulted in an increased share of capital going to companies in non-OECD countries, which in 2003 was about 35%, compared to 20% in 2000.

During the subsequent IPO "recovery" between 2004 and 2007, the relative amount of equity raised by companies from non-OECD countries continued to increase. During this phase, however, their increased share is not explained by a fall in equity raised by companies based in OECD countries. Rather, it is the result of a faster absolute increase in equity raised by companies from non-OECD countries. In 2003, non-OECD companies raised a total of USD 16 billion of equity worldwide, which in 2007 had risen to USD 130 billion. As a consequence, during the four "recovery" years before the 2008 financial crisis, non-OECD companies received almost 40% of all equity raised in the world. This share has increased even further in the period following the financial crisis. Between 2008 and 2012, almost 60% of all new risk capital raised worldwide went to companies from non-OECD countries.

Figure 2.2. Global trends in primary equity markets

Number of initial public offerings worldwide and the amount of equity raised by OECD and non-OECD corporations (2012 USD, billions)



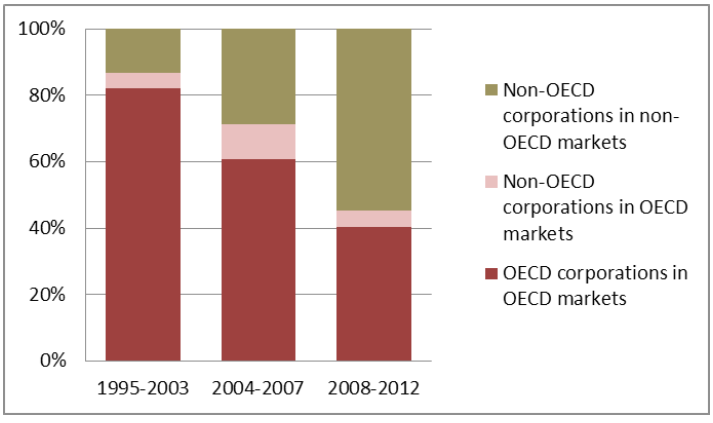
Source: based on data from Thomson Reuters *New Issues Database*, Datastream, stock exchanges' and companies' websites.

The developments illustrated in Figures 2.1 and 2.2 are summarised in Figure 2.3, which illuminates two important developments. The first is a significant and successive shift in the "IPO market share" from OECD to non-OECD economies. From initially providing less than 20% of all equity capital raised in the world, in the last five years (2008-2012) non-OECD markets have provided almost 55% of all equity raised through IPOs.

Second, Figure 2.3 shows that the dominant category of firms raising equity through IPOs are from non-OECD countries, accounting for 60% of all proceeds during the period 2008-2012. It also indicates that the increase in companies from non-OECD countries that raised equity in OECD markets during the "recovery" period (2004-2007) has come to a halt and been substituted for an increased reliance on non-OECD equity markets.

Figure 2.3. Global shift in equity markets

Relative share of equity raised through initial public offerings by OECD and non-OECD corporations and its distribution between OECD and non-OECD equity markets



Note: OECD corporations' fundraising in non-OECD markets throughout the period was insignificant and is not included in the figure.

Source: based on data from Thomson Reuters New Issues Database, Datastream, stock exchanges' and companies' websites.

2.3 The primary equity market in the United States

The developments described in Sections 2.1 and 2.2 are obviously influenced by the situation of the equity market in the United States, which has traditionally been the world's leading venue for IPOs.

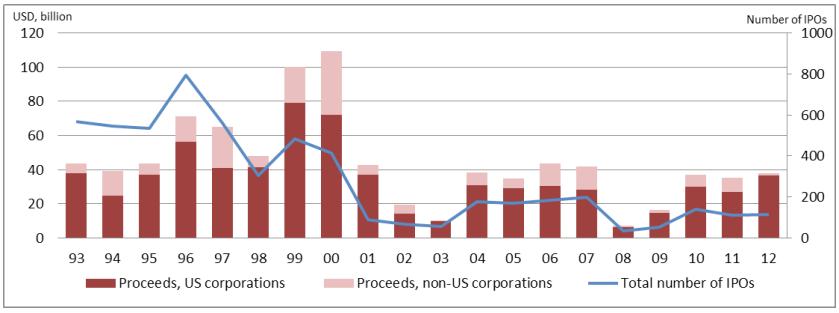
Figure 2.4 shows that in terms of the number of companies getting listed, a relatively clear downward trend began in the late 1990s. The annual average number of companies that made an initial public offering in the period 1993-2000 was 525. For the period 2001-2012, that number had fallen by about 80% to 116. The amount of capital raised also fell quite dramatically between the two periods, from an annual average of USD 65 billion to USD 30 billion.

Since the decrease in the total amount of equity raised was relatively smaller than the absolute number of IPOs, the average value of an IPO approximately doubled in real terms, from USD 123 million in the period 1993-2000 to USD 259 million in the period 2001-2012. Under the assumption that the average free float ratio for an initial offering was 25%, this means that the average market value of the companies that sought funding in public equity markets in the United States was about USD 1 billion.

One final observation from Figure 2.4 is that the absolute amount of equity raised by non-US firms through an IPO in US markets has also decreased quite considerably compared to the period from 1993 to 2000.

Figure 2.4. Trends in primary equity markets in the United States

Total number of initial public offerings, proceeds of US and non-US companies (2012 USD, billions)



Source: based on data from Thomson Reuters New Issues Database, Datastream, stock exchanges' and companies' websites.

2.4 The primary equity market in the United Kingdom

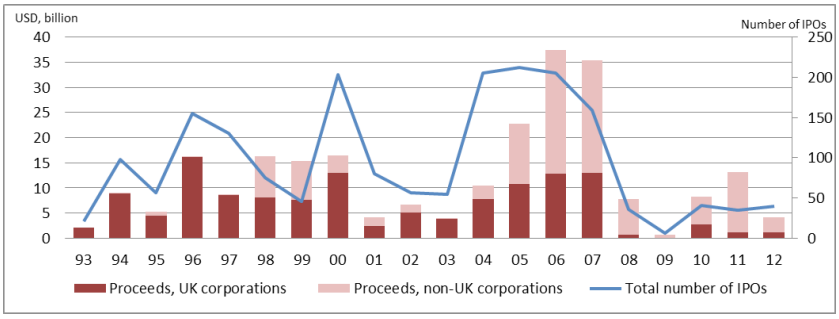
While the picture in the United States is fairly clear, the United Kingdom, which has historically been the world's second largest IPO market, demonstrates a somewhat more complex picture. Figure 2.5 shows that, in particular, during the "recovery" period

2004-2007 the annual amount of equity raised through IPOs substantially exceeded the amounts raised during the 1990s. While the average annual amount raised in 1993-2000 was USD 11 billion, the average amount raised in the recovery period years before the financial crisis (2004-2007) was no less than USD 27 billion.

However, the figure also shows that the difference between the two periods can largely be explained by equity raised by non-UK companies. In contrast to the 1990s, more than 61% of the funds raised in 2005-2007 went to non-UK corporations. In the aftermath of the financial crisis, IPOs by UK companies has almost come to a halt. And while they still totally dominate the scene, public offerings by non-UK corporations have not been large enough to match the overall IPO activity of the 1990s.

Figure 2.5. Trends in primary equity markets in the United Kingdom

Total number of initial public offerings, proceeds of UK and non-UK companies (2012 USD, billions)



Source: based on data from Thomson Reuters New Issues Database, Datastream, stock exchanges' and companies' websites.

When analysing the United Kingdom's IPO market, it is also interesting to examine in some detail the character of the reported new listings. According to data provided by the London Stock Exchange, 3 449 non-financial corporations were listed on the exchange between 1995 and 2011. However, of these listings, only half (54%) were listed through an IPO. Instead, they were listed mainly through "introduction", which means that they joined one of the markets of the exchange without raising any new capital.

Of the remaining 1 859 reported listings (mainly in the alternative investment market, AIM) that actually were in the form of an IPO, 83% were conducted through a private placement where shares are only issued to a selected group of institutional investors without

a public prospectus. This means that only about 300 of all of the companies that listed on the London Stock Exchange between 1995 and 2011 were seeking broad public funding issuing a prospectus.

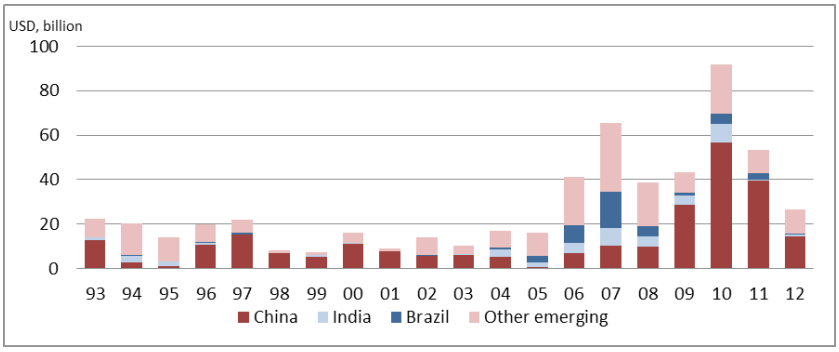
With respect to the private placements on the AIM market, a 2012 study by Vismara *et. al*. reports that private placements in London "never develop liquid trading, and the aftermarket performance has been poor, with an average three-year buy-and-hold abnormal return of -27.5%" (cited in Gao *et al*., 2012).

2.5 Primary equity markets in emerging markets

Already during the 1990s, public equity markets in emerging markets were at par with the London Stock Exchange in terms of equity raised. In fact, total proceeds from public offerings in emerging markets exceeded what was raised in London for every year between 1993 and 1997. But as shown in Figure 2.6, the real increase came in 2006 when the value of IPOs in emerging equity markets reached the same level as in the United States. This trend has continued and in 2010 the total value of IPOs in emerging markets was about USD 90 billion, which was almost twice the amount of equity raised through IPOs in the markets in the United Kingdom and United States combined. This growth in recent years is mainly attributable to an increased value of IPOs in China. As a matter of fact, in 2010, China overtook the United States as the largest primary equity market in the world.

Figure 2.6. Trends in primary equity markets in emerging markets

Amount of equity raised in non-OECD markets through initial public offerings (2012 USD, billions)

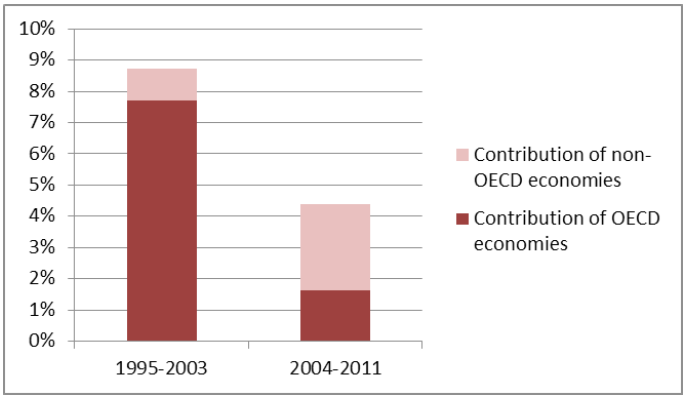


Source: based on data from Thomson Reuters New Issues Database, Datastream, stock exchanges' and companies' websites.

The increase in the number of listed companies in emerging markets has obviously had an impact on market capitalisation. Figure 2.7 shows that from having made only a marginal contribution to the growth in the overall stock market value during the period 1995-2003, since 2004 non-OECD countries have contributed almost 65% of the growth in global equity market capitalisation.

Figure 2.7. Contribution to global market capitalisation growth

Annual average of market capitalisation growth



Source: based on data from World Bank *World Development Indicators*.

From a corporate governance perspective, one important consequence of the changing IPO and stock market landscape worldwide is the impact on ownership structure in individual companies. Most of the corporate governance debate is focused on situations with dispersed ownership, where the battle for wealth is a zero-sum game between dispersed owners on the one hand, and incumbent management on the other. This "agency" approach has its merits, but it also has important limitations, since a very large, if not dominant, part of listed companies around the world actually have a controlling (or dominant) owner. It is reasonable to assume that on a worldwide scale, developments in terms of new listings towards emerging markets have increased the dominance of controlled companies.

Broadly speaking, the decline in IPO activities, the increase in delistings and private equity activities, and the shift towards emerging markets have all been in favour of controlling ownership structures. These developments have resulted in a decrease in the number of locally listed companies in countries that are usually characterised as having a predominantly dispersed ownership pattern, namely

Australia, the United Kingdom and the United States (IOSCO, 2007).[2] In 2000, locally listed companies in these three countries (excluding investment funds) represented 22.5% of the world's listed companies. In 2011, they only represented 16.3%. One could argue that the predominance of the dispersed ownership perspective in the public policy discussion is based on their high share in total market value rather than the number of corporations. However, the share of global market capitalisation of "dispersed" markets has decreased by some 30% – from 56% to 40% in the same period.

Another indication regarding the change in ownership concentration in listed corporations is the relatively low level of free float in emerging equity markets. For instance, while the average free float ratio for US and UK listed companies is about 90%, it is less than 35% in China, India and the Russian Federation (Goldman Sachs, 2010). In sum, the global change in IPO activities described above suggests a considerable reinforcement of concentrated ownership as the dominant "ownership structure" at company level in listed companies worldwide.

Despite the substantial growth of emerging equity markets, the McKinsey Global Institute still projects a future shortage of equity in emerging markets, particularly in China. The analysis, based on a "moderate" GDP growth scenario, projects that the accumulated need for equity over the next decade for new listings and secondary offers will be USD 18.4 trillion. The supply of equity, however, is only estimated at USD 8.2 trillion, resulting in what they call a USD 10.2 trillion "equity gap". While there is an ongoing shift of global financial assets towards emerging markets, the expected "gap" is largely explained by demographic changes, a traditionally low appetite to invest in listed companies and underdeveloped capital markets. One of the means the report suggests for attracting more capital to the equity market is improvements in corporate governance.

[2] A recent study showed that among S&P 1500 companies in the United States, the number with a controlling owner has increased over the last decade, from 87 to 114. Moreover, the study notes that the issue of control receives a lot of attention since some large companies that recently went public have a controlling structure, such as Linkedin Corp, Zynga Inc., Groupon Inc. and Facebook Inc. (IRRC and ISS, 2012).

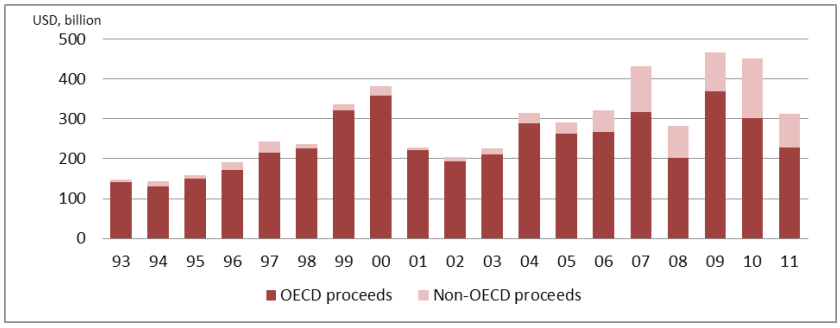
2.6 Secondary offerings

The role of public equity markets in providing new risk capital is not limited to IPOs. Equity markets should also serve already listed companies that can raise equity through a so-called secondary public offering (SPO). Figure 2.8 illustrates SPOs in OECD and non-OECD economies during the period 1993-2011. It demonstrates that in every year for the last decade, SPOs by non-financial companies based in OECD countries exceeded the proceeds from IPOs. In 2007, the amount of equity raised through SPOs was more than double that from IPOs. In 2009, the amount of equity that companies in OECD countries raised through SPOs was more than 14 times the amount that they rasied through IPOs.

It is worth noting that record levels were reached in the two years following the financial crisis. The tightening of corporate credits after the 2008 crisis seemed to result in an increase in secondary offers in equity markets. This may indicate that the aggregate amount of liquidity held by listed companies does not exclude a need for external equity finance for the corporate sector as a whole. As noted in Section 2.1, the figures do not include equity raised by financial corporations and investment funds. Further industry level and company size analysis would be useful to better understand any patterns in financing needs for different categories of non-financial businesses. Developments in aggregate corporate savings are discussed in Section 2.8.1.

Figure 2.8. Global secondary public offering trend

Total amount of equity raised through secondary public offers (2011 USD, billions)



Note: This figure does not cover financial corporations or investment funds. It covers all share issues of listed companies after the initial offer. After consolidating duplications into one single SPO and removing SPOs without sufficient information, the total number of unique SPOs covered is 74 015 for the period 1993-2011.

Source: based on data from Thomson Reuters *New Issues Database*.

2.7 Delistings and share buybacks

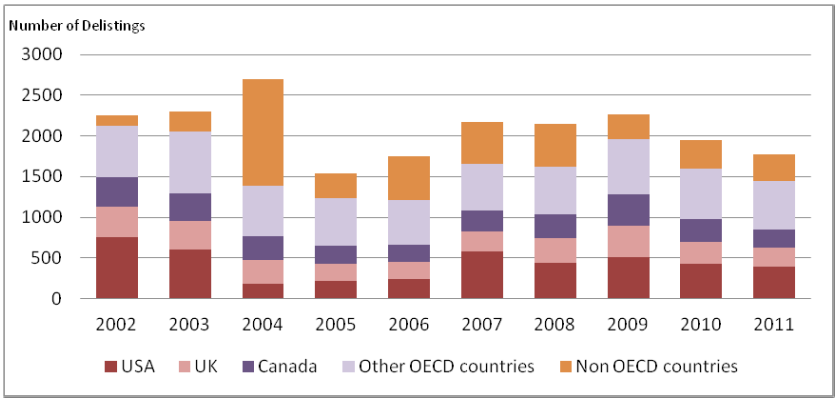
The total number of listed companies is not affected uniquely by the number of IPOs. It is also influenced by the number of corporations that, for different reasons, are leaving the public equity market. Since 2002, an annual average of 2 000 companies have delisted from stock exchanges worldwide. This means that almost 41% of the listed companies in 2002 have delisted over the last ten years.[3] Figure 2.9 shows that between 2002 and 2011, 78% of the delistings were from stock exchanges in OECD countries. Although some companies left the stock exchanges voluntarily through mergers, others delisted due to backruptcy or were forced to by the stock exchanges on which they are traded as they failed to meet continuining listing criteria (Macey *et al.*, 2008). It is important to note that delisting from a stock exchange does not necessarily mean that the company becomes privately-held. In the case of dual listings, for example, a company may be delisted from one exchange but remain

[3] In 2002, there were 50 086 listed companies worldwide. Between 2002 and 2011, 20 347 companies delisted from stock exchanges. Some of the delisted companies were companies that had also listed in that period (World Bank and WFE data).

listed on the other exchange(s), or a company may just change its trading venue and move to a new exchange or the OTC market.

Macey *et al*. (2008) examined more than 9 000 delistings for the period 1999-2004 in the US market. They showed that more than half of the delistings were "involuntary". As expected, bankruptcy was one of the main causes; however, failure to maintain minumum asset or market capitalisation requirements and price drops under a minimum price requirement (USD 1) were also important factors.

Figure 2.9. Number of delistings



Note: Unlike IPO and SPO data, delistings also cover financial sector corporations.
Source: World Federation of Exchanges.

Just as listing may be a natural step in the lifecycle of a company, voluntary delisting may also be appropriate and economically efficient at a certain stage. Voluntary delistings can be classified into two broad categories: going private, including delistings due to merger and acquisitions (M&A), and "going dark". In going private, a listed companies' insiders or outsiders buy existing shares from the company's investors and make the company privately held. In a going dark transaction, however, there is no tender offer or share buybacks to make the company private; instead companies delist from a regulated market and move trading to an OTC market (Marosi and Massoud, 2007).

Going private transactions in countries with dispersed ownership structures (such as the United Kingdom and the United States) are mainly in the form of leveraged buyouts (LBOs), where the listed company is acquired by a private equity investor through substantial borrowing and then delisted from the exchange. In countries with

concentrated ownership structures (most continental European countries), buyout transactions are often characterised by squeeze-out transactions, where controlling owners take the company private by compensating the minority shareholders (Djama *et al*., 2011).[4] Low interest rates, bountiful global liquidity and savings, increases in equity finance costs after the dot-com bubble, and high corporate governance pressure after Sarbanes-Oxley have been important factors driving the trend of increasing private equity LBOs (Blundell-Wignall, 2007), which has been an important driver behind voluntary delistings.

In a study concerning the rationale for going dark, Leuz *et al*. (2008) examined factors relating to the cost of compliance and agency conflicts. They found that increased compliance costs after the Sarbanes-Oxley Act was an important factor behind the trend; but they also found that controlling owners took their firms dark to protect private benefits of control and decrease outside scrutiny. Another study on delistings from the London Stock Exchanges' AIM market indicates that the inability to raise additional funding was a major rationale for delisting and that delisted firms had significantly higher leverage compared to those that remained listed (Pour and Lasfer, 2011). Marosi and Massaoud (2007) support the importance of compliance costs, particularly for smaller companies, as well as the theory that the firms that went dark had a higher leverage. They also indicate, however, that companies with fewer growth oppurtunities, greater insider ownership, lower institutional ownership and lower market momentum are more likely to go dark.

Studies indicate that (apart from high leverage opportunities over the first decade) decisions to go private are driven by factors similar to those for going dark. A study of French buyout offers (Serve and Martinez, 2010) also found that companies that went private performed worse than their peers, with low levels of liquidity and financial visibility. In addition, it has been claimed that the French Financial Security Law that was enacted in 2003 led to additional costs and contributed to delistings.

In many countries, delistings have been coupled with a trend of share buybacks. Depending on the technique that is used, a share

[4] For example, a study of Djama *et al*. (2011) revealed that 300 companies went private in France following a squeeze out while only 50 were taken private by LBO transactions during the 1997-2006 period.

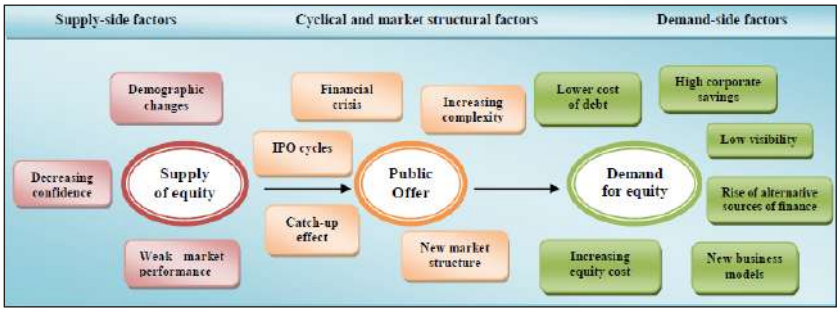
buyback can, in some cases, be seen as an inverse public offering by reducing the companiy's equity base (European Central Bank, 2007). Many explanations for the use of share buybacks have been provided and as early as 1966, Bierman and West argued that tax advantages of capital gains over dividends is the dominating motivation for companies to repurchase their own shares. The tax advantage still appears to be a commomly accepted explanation today, but other reasons have also been suggested, including the argument that buybacks give discretion to shareholders to opt in or out and to signal that the company is undervalued (OECD, 2007b).

In 1999, the share buyback volume in the United States exceeded the total dividends paid by non-financial companies for the first time and has since then remained a common way of returning money to shareholders rather than paying dividends (ECB, 2007). Share buybacks have been allowed or facilitated in other countries as well. In Japan, for example, the 2001 revision of the Commercial Code abolished restrictions on companies aquiring their own shares, allowing them to repurchase any number of shares for any purpose. After the regulatory change, share buybacks increased from USD 18 billion in 2001 to USD 52 billion in 2006 (Teng and Hachiya, 2011).

2.8 Explanations for the recent trends in primary equity markets

A number of explanations for the trends in primary equity markets have been offered in the public and academic debate. In this section, we divide these explanations into three main groups: *i)* factors that affect the demand for equity; *ii)* factors that affect the supply of equity; and *iii)* cyclical and market structural factors. Figure 2.10 provides a summary of the explanations, which are often interrelated. They may also differ in relative importance between countries, over different periods and for different company sizes and sectors.

Figure 2.10. Factors behind the recent trends in primary equity markets



2.8.1 The demand for equity

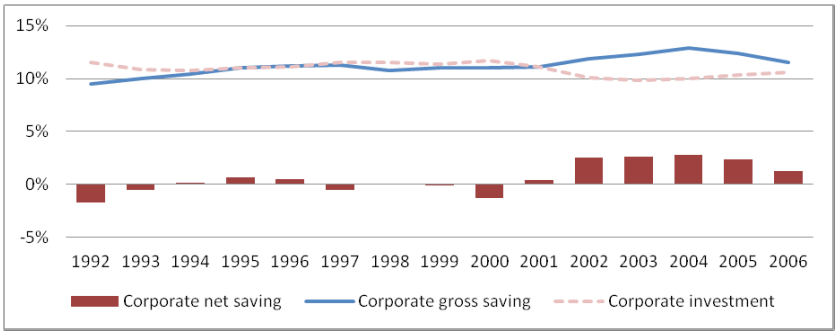
Companies' demand for equity capital is obviously one of the most important determinants of primary market acitivity (Lowry, 2003). Simply put, the need for external funding is determined by the difference between the level of investment and the amount of a company's savings. Once the need for external funding has been determined, the entrepreneur or the company will seek the best source of funding based on their analysis of the relative cost and conditions of the different sources.

Before the 2008 financial crisis, the global economy experienced important changes in both the level of business investment and corporate savings. Figure 2.11 indicates that after 2002, both corporate gross savings and investments moved to decrease the need for external funding. Across the OECD, the corporate sector as a whole moved from a net borrowing position to a net savings one.

Several explanations have been offered with respect to the trend in corporate savings, including: increased profitability in both the financial and non-financial sectors, low levels of corporate investments relative to GDP, a relative decrease in the price of investment goods and increased investments outside the OECD area (OECD, 2007b). It has also been observed that while operating profits do not appear to have been abnormally high during the period, overall profits were elevated due to low interest rates and a reduction of corporate taxes. Other explanations that have been offered for the increase in corporate savings include a decline in nominal interest rates and uncertainties associated with unfunded corporate pension liabilities, as defined benefit pension plans are estimated to be significantly underfunded (IMF, 2006). It has also been argued that

there is a liquidity motive caused by an increase in the volatility of net income over time (Boileau and Moyen, 2010).

Figure 2.11. Corporate saving and investment in OECD economies (% of GDP)



Note: Data include Australia, Canada, Denmark, Finland, France, Germany, Italy, Japan, the Netherlands, the United Kingdom and the United States. Net saving is not equal to the difference between gross saving and investment as it is also affected by changes in inventories and capital transfers.

Source: OECD (2007), *OECD Economic Outlook*, Vol. 2007/2, OECD Publishing, doi: *10.1787/eco_outlook-v2007-2-en*.

In order to understand how the observed changes in corporate savings may have influenced the demand for equity among non-financial companies, it is important to look at disaggregated data. While the decline in IPOs is focused on non-financial corporations, the reported corporate saving in Figure 2.11 also includes financial corporations. If we single out the financial sector corporations, we find that their contribution to the overall increase in savings during the peak period 2001-2005 was 20%, which is more than double their contribution to GDP over the same period (OECD, 2007b). To understand the true demand structure for equity among non-financial companies, it may not be sufficient to break the aggregate corporate savings numbers down between financial and non-financial firms; it may also be useful to analyse the difference in demand between large mature corporations on the one hand, and growth and medium-sized companies on the other.[5]

[5] Commonly used examples of large companies' high level of savings include the German engineering company Siemens' request for a banking licence to use its cash reserves to lend to customers (Economist, 2010) and Apple's accumulated USD 90 billion retained earnings as of 2011.

Modigliani and Miller's Proposition I in their influential study from 1958, which states that in perfect market conditions and without corporate taxes, the value of a company is independent of its debt/equity ratio (capital structure). This theorem has given the composition and cost of capital a central role in financial theory. But it has been widely misunderstood, and as stated by Miller (1988) 30 years after their seminal work, the "nothing matters" interpretation of the theorem is a grave misinterpretation of its conclusions. Rather, what their model intends to do is to help understand how *deviations* from perfect market conditions influence corporate finance decisions. Such deviations obviously include taxes and other financial and non-financial conditions, such as regulations, that are associated with different sources of funding – all with their specific characteristics. This also includes equity, which in itself is not a homogenous instrument. For example, are the conditions (and costs) associated with equity that is provided through a purely private deal different from equity that is provided through an initial public offering, which is associated with a number of expenses before, during and after the introduction? The ambition to minimise the cost of capital (thus maximising the value of the company) will take such differences into account and, for example, influence attitudes towards listing. As a consequence, if conditions are such that the relative cost of equity capital, for whatever reason, increases in public markets, companies are more likely to stay private (Bharath and Dittmar, 2006).[6]

At the same time that the cost of debt financing has decreased over the last decade, it is also argued that an increased regulatory burden on listed companies and higher intermediation costs have pushed up the relative cost of public equity financing.

The Sarbanes-Oxley Act of 2002 is usually at the centre of the regulatory burden discussion. In response to major corporate scandals of large public companies, the act was introduced in the United States *to protect investors by improving the accuracy and reliability*

[6] A tax advantage of debt financing over equity financing significantly affects the relative cost of debt and equity financing. However, this is a long-standing "problem" rather than a recent change. And, if anything, the decreasing trend of corporate tax rates globally have probably reduced the advantage of debt tax financing.

of corporate disclosure.[7] However, it has been argued that in the process of trying to restore public confidence, the act has also created a regulatory burden for public companies that has discouraged foreign and domestic companies from going public (Grant Thornton, 2010).[8] The Sarbanes-Oxley Act was followed by other regulatory initiatives around the world, particularly in countries which experienced corporate scandals, such as the Financial Security Law of 2003 in France and the Law on Savings of 2006 in Italy.

Against this background, today's policy discussions have come to focus more on the costs and efficiency of reporting and compliance requirements. For example, respondents to the interim report of the *Kay Review* (2012) indicated that *quarterly reporting and interim management statements fell into the category of useless and misleading information*. There was also a common claim that it had led to a focus on *making the numbers* at the expense of long-term growth and development of the business. Following the *Kay Review*, the UK government has put forth a draft regulation for comments that aims at removing several reporting requirements from all or some companies (Department for Business, Innovation & Skills, 2012).

The *Kay Review* also addresses institutional factors that may have increased the cost of equity capital. The review concludes that there was wide agreement among respondents to its call for evidence that the cost of equity capital for companies is high by historical standards, while expected returns to equity investors do not appear to be abnormal. One of the two explanations[9] provided for this difference between the anticipated costs to companies and the returns to investors is the rising cost of intermediation, which decreases the ultimate return to savers on their investments and widens the gap between the cost of capital for the company and the returns to savers.

[7] Sarbanes-Oxley Act, *www.gpo.gov/fdsys/pkg/PLAW-107publ204/pdf/PLAW-107publ204.pdf*.

[8] The report notes that market structural changes, such as online brokerage and decimalisation (decreasing the smallest increment for a stock price movement), were significantly more damaging to the IPO market than the regulatory burden caused by the Sarbanes-Oxley Act.

[9] The *Kay Review*'s second explanation for this difference is the divergence of companies' perception of their cost of capital and investors' perception of their returns, which is also a result of the lengthening of the investment chain that comes with intermediation, together with the growth in the complexity of the modern corporation.

It has sometimes been argued that the demand for equity raised in public markets has been substituted for an increased reliance on so-called private equity funds, which in turn are highly leveraged through the use of relatively inexpensive debt. Recorded assets under private equity management did experience a spectacular surge until 2007.

However, in order to assess the role of private equity in replacing equity raised in public markets, we must look at the amount of equity that private equity firms actually supply to companies. The total value of assets under management by private equity firms was estimated to be USD 3 trillion at the end of 2011 (Preqin, 2012). However, about one-third of this capital (USD 927 billion) is in the form of so-called "dry powder", which is capital that is not invested (Bain & Company, 2012). The remaining USD 2 trillion is invested in different asset classes, including real estate. As a result, and excluding dry powder, the total global investments of private equity firms in 2011 is estimated to be about 4% of global market capitalisation.

One could argue that since private equity is a relatively new phenomenon, the accumulated investment value of private equity firms should be expected to be fairly low compared to total market capitalisation. However, flow figures indicate a relatively modest role of private equity as a source of equity funding. Despite the sharp increase in private equity volumes and a decrease in IPOs, the average global buyout deal volume between 2001 and 2011 was considerably lower than the amount raised through primary markets in the same period (USD 259 billion compared to USD 450 billion worldwide).

Unlike equity raised in public markets, the private equity investment model does not necessarily imply the injection of long-term risk capital to companies. A large part of private equity transactions can be classified as trade activities in secondary markets rather than a primary supply of risk capital. For instance, more than 50% of the buyout transactions in Europe in 2011 were private equity to private equity transactions (Bain & Company, 2012).[10]

[10] The recent regulatory initiatives in Europe, such as Solvency II, are claimed to cause a decrease in the private equity investments of some financial groups and significant offloading of long-held stakes in private equity funds (Pignal, 2012).

Another explanation of why companies may demand less equity from public markets is offered by Gao *et al*. (2012). After studying more than 7 400 IPOs in the United States between 1980 and 2009, they suggest that there has been a fundamental change in corporate growth strategies. They argue that an increased importance of bringing products to market quickly has resulted in lower profits for independent small firms relative to the potential profits generated as part of a larger organisation that can realise economies of scope. The result has been a strategic re-orientation of small companies away from organic growth with the help of an IPO to a strategy of mergers or acqutisiton.

Another important factor that has been claimed to erode the incentives for entering the public equity market is the lack of visibility in today's equity market environment. The dominance of short-term trade practices, indexing and exchange-traded funds (ETFs) are criticised for moving liquidity to large companies and leaving the stocks of the remaining small companies illiquid (Bradley and Litan, 2010). Together with the lack of long-term focus, the emphasis on short-term trading has also resulted in a decrease in analyst coverage, which is argued to have further undermined the incentives of growth companies to enter the public equity market (Doidge *et al.*, 2011).

2.8.2 The supply of equity

The willingness of savers and intermediaries to supply corporations with equity through primary markets depends on a range of factors that influence the relative risk-adjusted rate of return on equity compared to other investment opportunities. While it may be hard to quantify, that assessment also includes the investor's perception of trust (or confidence) in market mechanisms and market institutions.

As a consequence, it is no surprise that explanations for a change in equity supply by savers and intermediaries include a decrease in investor confidence, which was supposedly eroded both by corporate scandals, not least in the financial sector, and perceived failures in the way equity markets are supposed to function. The Chicago Booth/Kellogg School Financial Trust Index, which measures trust in financial markets, reports that only 15% of the respondents in

mid-2012 had trust in the stock markets. This is the lowest level among all of the elements included in the index and barely half of the trust reported for the banking sector (Sapienza and Zingales, 2012).

Factors that are suggested to contribute to a decrease in trust include developments in terms of the equity market structure and trade practices. Particular attention has been given to the effects of market fragmentation and the growth of dark pools that may distort the quality of the price discovery process (IOSCO, 2011a; European Commission, 2010). High frequency trading (HFT), where certain traders may obtain privileged access to market information through dedicated data feeds, has also been subject to discussion (Linton and O'Hara, 2012). In terms of market failures, the US Securities and Exchange Commission (SEC) recorded that the so-called Flash Crash event was followed by a fairly substantial withdrawal of equity from equity markets by some traditional institutional investors, such as mutual funds (Schapiro, 2010).

A report by Grant Thornton entitled *Market Structure is Causing the IPO Crisis – and More* (Grant Thornton, 2010) argues that the decline in IPO activities is caused by unintended consequences of uncoordinated regulatory changes and inevitable technological advances. The report claims that the new market structure promotes speculative and complex trading practices at the expense of long-term investing based on corporate fundamentals. It has also been claimed that market developments have reduced trade in the shares of smaller companies (Friederich and Payne, 2011), which provides less liquidity and fewer incentives to go public (Bradley and Litan, 2010).

Another explanation for a structural decrease in the supply of equity in primary markets is the ageing population in some major economies, especially in Europe and Japan, which is supposed to influence the balance of asset allocation from equities to fixed-income securities. The McKinsey Global Institute (2011) has estimated that European investors 30-65 years old allocate 35% of their savings to equities, while persons over 65 only allocate 20%. Together with possible regulatory restrictions on the asset allocation of institutional investors, such as pension funds and insurance

companies, it is argued that we will experience a successive decrease in the appetite for equity.[11]

2.8.3 Cyclical and structural factors

Trends in IPO developments have also been explained by cyclical variations that are driven by the relationship between the volume of IPOs and intial returns. A study by Lowry and Schwert (2002) indicates that IPOs that are followed by high and increasing initial returns tend to be followed by an increasing number of companies going public, which in turn leads to periods of lower initial returns. This pattern, they claim, was repeated several times in the US market between 1960 and 2001. One explanation for such cycles is that in their evaluations, underwriters seem to be biased in favour of the recent IPO valuations relative to corporate fundamentals (Lowry and Schwert, 2002). Another, fairly straightforward, explanation for variations in the number and size of IPOs is the influence of general market conditions. When market conditions worsen, stock prices drop and companies stay private to wait for more favorable conditions before going public (Pastor and Veronesi, 2005).

The "catch-up effect" refers to the tendency of countries that start at a lower level of economic activity to grow faster than those that have already obtained a high level of economic activity (IMF, 2012). This phenomenon may help to understand the global shift in primary markets towards non-OECD countries. Today, most countries have an established stock market infrastructure and have adopted regulatory frameworks that make it possible for companies to raise funds domestically. Since initial public offerings by non-OECD corporations in OECD markets as a whole has always been limited (4.5% between 1995 and 2003), the decline in IPO activities in OECD markets cannot be explained by a shift of non-OECD corporations fundraising from OECD to non-OECD markets.

[11] The regulatory changes related to insurance and pension funds are sometimes criticised for reducing the supply of equity (Kay Review, 2012). Solvency II, which is likely to be applicable from 1 January 2014 and will regulate the European insurance sector's capital adequacy requirements, has raised particular concerns (Rolet, 2012).

On the contrary, as shown in Figure 2.6, there has actually been a substantial absolute increase in non-OECD primary markets since 2005.

2.9 Policy responses to the initial public offerings crisis

Two important policy initiatives undertaken by OECD countries in response to the IPO crisis are the JOBS Act (Jumpstart Our Business Startups Act) in the United States that was signed into law by President Obama on 5 April 2012 and the *Kay Review* commissioned by the UK Secretary of State for Business, Innovation and Skills. In September 2012, The UK Department of Business, Innovation and Skills (BIS) also announced an initiative with the London Stock Exchange aiming to stimulate access to equity for growth companies.

As defined by the JOBS Act itself, its ultimate objective is "*to increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies*". Mainly, the act defines a new type of issuer, an emerging growth company, that had total gross revenue of less than USD 1 billion and who could benefit from reduced regulatory and reporting requirements for a period of up to five years from its IPO. These reduced regulatory and reporting requirements basically involve financial reporting requirements for prospectuses, scaled executive compensation disclosure and the auditor attestation of internal control over financial reporting. The act also raised the limit of the small issue offering exemption from SEC registration requirements from USD 5 million to USD 50 million within any 12-month period as well as the shareholder threshold to register a class of equity securities with the SEC from 500 to either 2 000 persons or 500 or more persons who are not accredited investors.

The *Kay Review* aims to "*review activity in UK equity markets and its impact on the long-term performance and governance of UK quoted companies*". It provides a comprehensive analysis of the UK secondary market and draws conclusions that are also relevant to other OECD economies. In addition, the most recent policy response from the BIS, which makes explicit reference to the United States' JOBS Act, is described in their press release as follows:

> In further action to make Britain one of the best places in the world to start, run and grow a business, the [g]overnment has developed a set of ambitious proposals with London Stock Exchange to attract entrepreneurs and high-growth companies. Proposals will include a planned new route to the UK IPO market for high-growth companies, which is likely to feature reformed rules on free float, eligibility criteria and reporting requirements. … In addition, [the g]overnment will also investigate the current regulatory rules that may be deterring investors from funding growth companies, and will work with London Stock Exchange to widen the availability of equity capital for both UK and international businesses looking to make the UK their global base. (Department of Business Innovation & Skills, 2012d)

In November 2012, the UK government released its response to the *Kay Review*, stating that "*the [g]overnment accepts Professor Kay's analysis and the conclusions of his report*". Particularly, the government's detailed response to the *Kay Review*'s 17 specific recommendations are mostly supportive, including the establishment of an investors' forum as a mechanism for collective action, removal of mandatory quarterly reporting and full disclosure of costs and charges in the investment chain. However, there are also critical approaches to the conclusions of the review. For instance, the National Association of Pension Funds (NAPF), while noting that to a large extent they endorse the conclusion that the investment chain is too long and costly, stated that they "*were underwhelmed with the proposed solution to address this which largely boiled down is: leave it to the market.*"[12]

3. Efficient Allocation and Developments in the Secondary Equity Markets

While the economic relationship between capital formation and growth is well established, it is not only the *absolute* amount of investment that is important. Equally important for innovation and growth are the conditions under which capital is made available and

[12] NAPF, Business, Innovation and Skills Select Committee; Inquiry into the *Kay Review* of UK Equity Markets and Long-Term Decision Making, *www.napf.co.uk*.

the efficiency with which the market can allocate capital among different possible uses. With respect to equity, the degree of allocative efficiency will, to a great extent, depend on the incentives and ability of shareholders to actively seek and use information about the long-term prospects of the companies in which they invest.

This is why the *OECD Principles* assign considerable importance to the quality of disclosure and transparency that will help shareholders perform this task by having equal and timely access to information.

But information that is made publicly available is not enough. Genuine value creation in society also requires that shareholders have the incentives to individually, and at their own expense, seek, analyse and use information that they gather themselves. The constant search for such idiosyncratic information can be seen as an investment by the shareholder, and fills the socially important function of bringing new and unique knowledge to the economy. This does not necessarily mean that shareholders themselves engage in entrepreneurial activities. But it does imply that they take a genuine interest in understanding the full long-term economic value of such activities among the plethora of investment opportunities that are available to them in the economy. When the shareholders' interests are aligned with the long-term performance of the company, seeking and using this knowledge will contribute to identifying and supporting long-term value creation. Obviously, it may in some cases also generate information on how to make better use of corporate resources in a way that other shareholders and the incumbent managers do not understand or want to exploit.

Since legal and economic doctrine assumes that shareholders actually have the incentives to seek information about the long-term prospects of the corporation, they are also given a set of rights to act on this information by influencing the direction of corporate activities. These rights are mainly formulated in Section II of the *OECD Principles*. To make informed use of these rights and thereby support the corporation's long-term performance is a key shareholder function that is essential to the effective allocation of capital.

Needless to say, collecting, analysing and using information (be it publicly available or self-generated) is associated with costs – sometimes considerable – for the shareholder. In order to motivate these costs, shareholders must be able to expect corresponding private

gains from this socially beneficial "generation of new knowledge". These private gains can come from different sources and range from simply buying a stock that is expected to rise in value to more discretionary gains associated with a complete takeover aiming at realising unexploited values and business opportunities.

This part provides an overview of market developments that may have influenced shareholders' incentives and capability to carry out these key corporate governance functions. For that purpose, it is important to know who the owners are, why they hold their shares, how they hold them and how they trade. Section 3.1 looks at the character of today's investors, keeping in mind the difference between direct investors and institutions that typically serve as intermediary investors between the ultimate saver and the company. We also note that institutional investors come in many different shapes and forms, with different business models, investment strategies and trading practices that may influence their incentives and their ability to carry out their corporate governance tasks. Section 3.2 describes developments in terms of equity market structures and trading practices, notably market fragmentation, HFT, ETFs and the use of dark pools. Section 3.3 discusses related corporate governance issues and recent policy concerns.

3.1 Who are the owners?

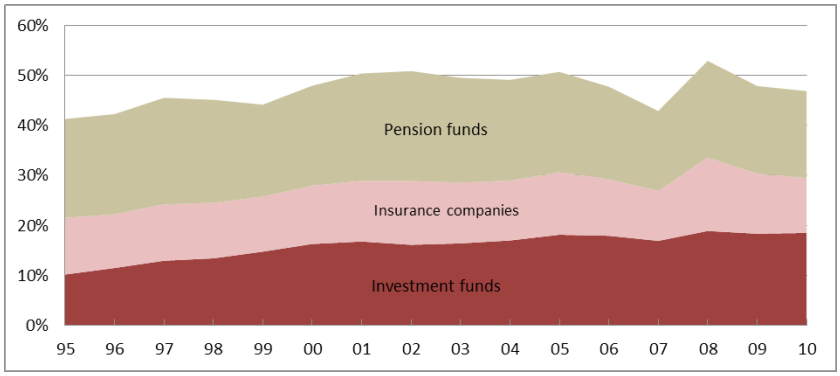
Over the last 50 years, the ownership structure of listed companies in most OECD markets has moved from direct ownership to intermediary ownership. In the United Kingdom, for instance, direct individual ownership in listed companies has decreased from 54% to only 11.5%. In the United States, direct ownership has dropped from 84% to 37%.[13]

In 2010, pension funds, mutual funds and insurance companies held nearly half of the listed equities in the world, with a total market value of USD 26 trillion (Figure 3.1). This is an increase of about 40% in 1995. It is worth noting that these numbers are calculated based on the total market value of the corporations, which means that the institutional ownership of the global free float is likely to be considerably higher. Within each of these three broad categories

[13] The UK Office for National Statistics and the US Federal Reserve.

of institutional investors, there is a great variety in terms of business models, investment strategies and trading practices.

Figure 3.1. Share of institutional investors in global equity markets (% of total market capitalisation)



Note: Institutional investor data do not cover non-OECD countries; however, large non-OECD economies' institutional investors' investment in the global public equity market is estimated to be quite low compared to OECD economies (OECD, 2011).

Source: based on institutional investors' investments in "share and other equity" data from OECD Institutional Investors Statistics and market capitalisation data from World Bank World Development Indicators.

Compared to the traditional institutional investors identified in Figure 3.1, hedge funds, private equity funds and sovereign wealth funds are estimated to hold relatively smaller portfolios of public equity. The total assets under management of the hedge funds are estimated to be USD 1.8 trillion, private equity funds USD 3 trillion and sovereign wealth funds USD 4 trillion.[14]

With increased international integration of equity markets, the share of foreign portfolio investors has increased in most countries. In the United Kingdom, the share of listed equity held by foreign investors increased from 7% to 41.20% between 1963 and 2010. In the United States, the share held by foreign investors increased from 2.24% to 13.03% over the same period (UK Office for National Statistics; US Federal Reserve). In Japan, the share of foreign investors in the equity markets increased from 4.4% to 26.9% between 1989 and 2011 (Bank of Japan).

National data do not identify foreign owners with respect to their category (for example, pension fund, household, insurance com-

[14] Hedge funds, 2011, IMF; Private equity and SWFs, 2011, Preqin.

pany, etc.). As a consequence, the increase in "foreign ownership" makes it increasingly difficult to track the relative importance of different categories of owner at a national level. While a global increase in equity holdings by institutional investors can be observed, some national data actually indicate a decrease in institutional investors' share in local markets, at the same time as an increase of foreign shareholdings. This may result in a misinterpretation of trends in ownership structure, since a large portion of the foreign portfolio investors are likely to be institutions like pension funds, mutual funds and insurance companies. A comprehensive analysis of the relative importance of different categories of owners, their incentives and abilities to exercise corporate governance, needs to also include a breakdown of foreign investor into different categories.

A relatively new "category" of owner is institutions engaged in HFT, which is typically carried out as proprietary trading. High frequency trading has increased dramatically in recent years, and today more than 60% of the total volume of the US equity trade (Lash and Spicer, 2009) and 38% of European equity trade (IOSCO, 2011a) is generated by high frequency traders, such as hedge funds and investment banks. However, the dominance of these proprietary traders in terms of trading volume is not reflected in any increase in their share ownership. Banks and other financial institutions are estimated to hold only 1% of the shares in the US market.

Two main reasons have been provided for this discrepancy between trading volume and ownership. The first is that HFT almost per definition does not require a large portfolio. Second, it has been suggested that other actors, such as "foreign" institutions (for which we do not have ownership data) and traditional investors also engage in HFT and that they make up a significant portion of the HFT volume.[15] The second explanation is not likely, however, to alter the observations that entities dominating trading actually hold a very small portion of the total outstanding amount of shares.

Another important development in terms of trading practices has been the decrease in holding periods. The average holding period at the New York Stock Exchange fell from eight years in the 1960s to

[15] A survey (Foresight, 2011) among UK investors indicates that some traditional investors are aware that their brokers may be deploying HFT techniques to execute their orders.

around five days in 2010 (Kleintop, 2012). This was mostly caused by the boost of HFT and ETFs, and does not in itself indicate a more general trend of short-termism. Additionally, holding period data based on stock turnover may be misleading as the use of complicated investment strategies, such as high trade in continuously held stocks, has increased.[16]

Since the specific business models and investment strategies of intermediary investors directly influences their incentives and ability to exercise their corporate governance functions, additional empirical data concerning the relative importance of different categories of owners, their investment strategies and trading practices is desirable.

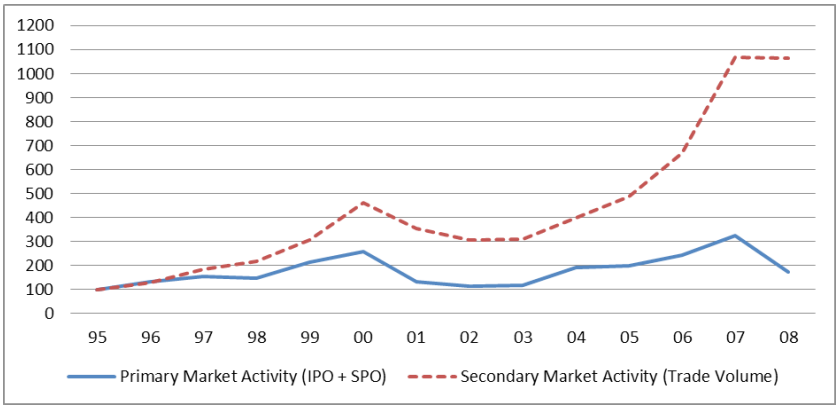
3.2 Changes in market structure and trading practices

The last decade has seen some fundamental changes in the structure of equity markets. These changes have been driven by both technological advancements and regulatory initiatives such as NMS in the United States and MiFID in the Europe. Trade practices have become more sophisticated, markets have become fragmented and new equity-based instruments have increased in importance.

Even if we limit ourselves to data from the "traditional" stock exchanges, trading in equity has increased much faster than the supply of new equity capital through initial and secondary public offerings. Particularly during the pre-crisis period, between 2004 and 2007, the increase in trade volume was three times the increase in primary market volume.

[16] A study of the United Kingdom's Investment Management Association (2011) claims that given the wide range of investors, stock turnover is not an appropriate indicator of holding periods and investment behaviour. By using the weighted value of continuous holdings, the study argues that 42% of total equity is continuously held by investment funds in the United Kingdom for five years or more.

Figure 3.2. Evolution of trade and the supply of new equity



Source: based on data from Thomson Reuters *New Issues Database*, DataStream, stock exchanges' and companies' websites. Trade volume data are from World Federation of Exchanges.

Together with the decline in IPO activities in OECD economies addressed in Part II, the fragmentation in equity markets, emergence of new investment techniques such as HFT and the rise of ETFs are major developments, discussed in Sections 3.2.1-3.2.3 below.

3.2.1 Fragmentation in equity markets

For a long time, services of stock exchanges were seen as similar to public utilities and often protected by a legal monopoly status which prevented the emergence of competitors (Di Noia, 1998). However, the integration of financial markets accelerated by technological advancements made it increasingly difficult for traditional stock exchanges to perform this important and "straightforward" function.[17] Like in many other industries, technological advancements also streamlined the quality of services in terms of market infrastructure. For instance, at the beginning of the competition era, nearly all European stock exchanges were using the same trading mechanism (Steil, 1996 cited in Di Noia, 1998).

The first demutualisation of the Stockholm Stock Exchange has been followed by an international trend towards demutualisation

[17] The United States' Securities Exchange Act of 1934 defines an exchange as "… which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities…"

with incorporated exchanges being listed on their own markets. During this process, the stock exchange industry has also experienced a considerable degree of consolidation both at a national and international level, such as the merger of the NYSE and Euronext in 2006, NASDAQ's acquisition of the OMX and the London Stock Exchange's merger with Borsa Italiana in 2007 (Christiansen and Koldertsova, 2009).

While the "registered" stock exchange industry has experienced consolidation, the "dark" part of the equity market has moved in the opposite direction. The result is that equity markets today are highly fragmented into traditional organised stock exchanges and non-exchange trading venues, such as alternative trading venues (ATS) in Canada and the United States, multi-lateral trading facilities (MTFs) in Europe, and broker networks (IOSCO, 2011a).

The fragmentation is not only between traditional stock exchanges and new venues for trading but also between so-called dark and lit markets. Table 3.1 indicates that in September 2009, 74.6% of US trade was executed in the registered exchanges (NYSE, NASDAQ and others) and five electronic communication networks. The remaining 25.4% was traded in 32 different dark pools and in more than 200 different broker-dealer networks that do not display "best-price orders" (SEC, 2010a). Although the use of dark pools has not reached the same levels as in Japan, there is still an upward trend. A study by IOSCO shows that during the last week of 2010, no less than 9.2% of total trade by value in Japan was executed in dark pools (IOSCO, 2011b).

Table 3.1. Estimated share of trade volume in the United States (%, September 2009)

Registered exchanges	63.8
Electronic communication networks	10.8
Total displayed trading	74.6
Dark pools (32)	7.9
Broker-dealer internalisation (>200)	17.5
Total undisplayed trading	25.4

Source: US Security and Exchange Commission (SEC) (2010), "Concept Release on Equity Market Structure", SEC, Washington, DC, *www.sec.gov/rules/concept/2010/34-61358.pdf*.

3.2.2 High frequency trading

One of the most important changes in trading practices over the last decade is the dominance of algorithmic trading, which means that orders are executed by computer-based systems according to a pre-designed set of rules and procedures. The characteristics of algorithmic trading are defined very broadly from agency activities (on behalf of clients) to proprietary trading (with own money), aggressive strategies (liquidity-consuming) to passive strategies (liquidity-supplying), and informed (try to predict very short-term returns) to uninformed (not trying to rebalance portfolios based on very short-term variation in returns) traders (Friederich and Payne, 2011). However, the current public discussion focuses primarily on one particular type of algorithmic trading, namely so-called high frequency trading (HFT), which also represents the largest and increasing share in trade volumes in some OECD markets.

Although there is no commonly accepted definition, the main features of HFT can be identified as proprietary trading, using extraordinarily high-speed computers with sophisticated software, applying co-location services and the use of individual data feeds that are offered for a fee by stock exchanges. HFT is also characterised by very short timeframes for transactions, cancelation of orders shortly after the submission and ending the trading day with a maximum flat position (SEC, 2010a). In 2009, HFT accounted for nearly 60% of the total trading volume in the US equity market (Lash and Spicer, 2009). In Europe, it represented some 38% of total trade volume in 2010 with an upward trend (IOSCO, 2011a).

From a corporate governance perspective, it is important to note that HFT is more than a technological advancement allowing high-speed computer trading. It can also be seen as an investment strategy with a very short-term focus. The ambition is not to assess and trade on genuine information concerning the long-term performance of any individual company. Rather, the strategy is heavily based on short-term arbitrage opportunities that are often obtained by unique and fast access to trading information.[18]

[18] Beside general characteristics, HFT covers a wide number of financial strategies with different market impacts, such as: market-making strategies, arbitrage strategies and directional strategies (IOSCO, 2011a).

Although technological advancements that make it possible to develop and adopt sophisticated and rapid computerised trading practices were the critical factors behind the increase of HFT, changes in the regulatory framework, trading rules and practices have also contributed to this rapid transformation. This includes regulatory reforms such as NMS in the United States, MiFID in Europe and Marketplace Rules in the Canada, that aimed at promoting competition in trading services (IOSCO, 2011a), decreasing the tick sizes[19] that make it easier for investors to engage in speculative activity (Grant Thornton, 2010) and the possibility of co-locating the computer servers of trading firms within the stock exchanges to gain faster access.

3.2.3 Exchange-traded funds

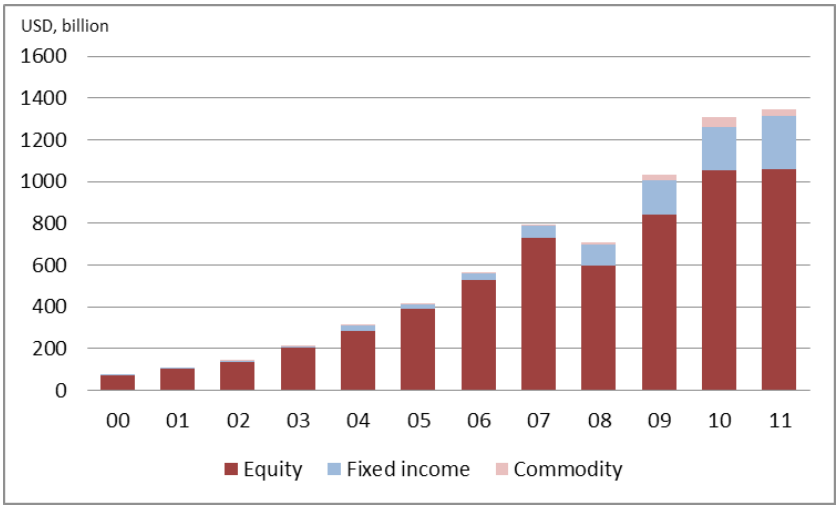
The increase of intermediary ownership has for a long time been coupled with a rise of passive investment strategies that are based on a closely pre-defined set of criteria. The most obvious example is various forms of index tracking, which has become an important "strategy" for a broad spectrum of investors (Rey and Seiler, 2001). Already in the beginning of 1990s, many pension funds allocated more than half of their investments in equities to indexes. Two important factors driving this development were that passive investment strategies (indexing) helped investors to dispose of heavy brokerage commissions and advisory fees, and that active institutional investors were unsuccessful in beating the market averages over time (Lowenstein, 1991).

In the mid-1990s, the use of indexing was taken to yet another level by the development of exchange-traded funds (ETFs). Since then, ETFs have emerged as alternative investment vehicles for both passive and active investment strategies. ETFs share the common characteristics of mutual funds but are also tradable like shares on exchanges (Ramaswamy, 2011). As a result, investing in ETFs makes it possible to both decrease the transaction costs and diversify the portfolio for passive investors, and at the same time follow an active strategy for holding and trading different ETFs. As shown in Figure 3.3, the total market value of assets under ETFs has grown dra-

[19] The smallest increment for a stock price movement.

matically during the last decade and, after a slight decrease in 2008 during the global financial crisis, reached USD 1 351 billion in 2011.

Figure 3.3. Global exchange-traded fund assets (USD, billion)



Source: BlackRock.

3.3 Issues and policy reactions

The developments in terms of institutional ownership, equity market structure and trading practices described in Sections 2.1 and 2.2 have all been discussed in relation to their impact on the incentives and ability to exercise long-term corporate governance. This section discusses four of the main concerns that have been raised, namely: *institutional ownership and misalignment of incentives; erosion of investor incentives and market trust; crowding out of long-term ownership; and decreased interest in using primary equity markets*. Brief examples of policy reactions or responses are provided for each of the areas.

3.3.1 Misalignment of incentives

In most OECD countries the majority of traded shares are held by intermediaries, such as pension funds, mutual funds and insurance companies, that basically invest the money of ultimate savers for a fee. While intermediation in itself lengthens and weakens the link between savers and corporations, the presence of proxy advisors, asset managers and other service providers in the investment chain

also make the corporate governance process more complex. With every additional actor, there is a risk that the ultimate saver's objectives becomes misaligned. This misalignment may not only be in terms of investment strategy but in terms of corporate governance priorities as well.

Since intermediary investors themselves differ in terms of their business models, their incentives and priorities in terms of exercising long-term corporate governance also differ. In the pursuit of effective policies, it is essential that policy makers develop a better understanding of the role and incentives of intermediaries. Such a taxonomy would go a long way to understand the effectiveness and rationale for individual corporate governance rules and regulations.

The move away from the traditional individual direct shareholders who experience a direct link between corporate performance and their own income, is recognised in the *OECD Principles* and makes "…the effectiveness and credibility of the entire corporate governance system and company oversight … to a large extent depend on institutional investors". However, the common expectation of *increasing demand for a voice in corporate governance* (OECD, 2004) due to the rise of professional investors has not always been met. One of the most straightforward explanations is simply that a great majority of intermediary investors actually lack the incentives to exercise their ownership functions.

In some countries, the response has been to introduce institutional investor codes to promote engagement in corporate governance and align institutional investors' interests with the ultimate savers. The key principle is that institutional investors should monitor their investee companies (UK Stewardship Code) and decide in a careful and transparent way whether they wish to exercise their shareholder rights (Dutch Corporate Governance Code). Despite such attempts, it has been argued that the 2008 financial crisis highlighted the problem of misaligned interests and that shareholders' lack of interest in corporate governance raises questions about the effectiveness of existing corporate governance rules (European Commission, 2010). The *Kay Review* (2012) also noted that the growth of intermediation has increased the potential for misaligned incentives, and together with the erosion of trust, is a major source of economic short-termism.

3.3.2 Lack of confidence, crowding out and the use of primary markets

Before the financial crisis, developments such as market fragmentation,[20] HFT, ETFs, co-location practices, indication of interests (IOI) and direct electronic access were generally welcomed. They were primarily seen as means to increase competition, drive down transaction costs, facilitate the execution of large-scale transactions and make trade faster and more accessible.

In recent years, however, concerns have also been raised that these developments in terms of equity market structure and trading practices have had an adverse impact on the incentives and behaviour of both investors and corporations. It is sometimes claimed that developments have eroded not only confidence in equity markets as a level playing field where all investors have the same opportunities but also the incentives to engage in long-term corporate governance. Second, it has been argued that current market conditions tend to crowd out long-term investors and strategies that focus on a fundamental analysis of corporate prospects. Third, it has been suggested that developments have made entrepreneurs and growth companies more hesitant to use primary equity markets as a source of funding. These issues are discussed below.

The complexity of today's equity markets means that the effects of different developments such as fragmentation and HFT on the incentives and ability to pursue long-term corporate governance practices cannot be analysed in isolation. Several different developments may simultaneously influence, for example, market confidence or investor incentives. There may of course also be counter-veiling forces. The complexity of the issues as well as the increased public scrutiny of market structures and trading practices, can be illustrated by the debate that followed the so-called Flash Crash in May 2010.

The Flash Crash was the largest price decline and reversal since 1929 in the US market; market indexes dropped more than 5% in 5 minutes and recovered almost entirely in the next 90 seconds; 324 company shares suffered price moves of more than 60% and

[20] The changing ownership structure of, and competition among, stock exchanges and its impact on the role of stock exchanges in corporate governance was addressed in the previous work of the OECD, see Christiansen and Koldertsova (2009).

exchanges cancelled more than 20 000 trades (Schapiro, 2010). The size and the complexity of the event made the Flash Crash somewhat of a defining moment in the discussion on market structure and trading practices.

The Flash Crash received additional public policy attention by the fact that it coincided with the end of the comment period for a Concept Release on Equity Market Structure issued by the SEC in January 2010 (SEC, 2010a). The Flash Crash was immediately followed by a critical address[21] by the SEC Chair, which, with references to "clear market failures",[22] moved the issues of market structure and trade practices to the top of the policy agenda.

Following the Flash Crash, a joint report by the US Commodity Futures Trading Commission (CFTC) and the US SEC (2010) concluded that one of the key lessons to be learnt from the event is that the interaction between automated execution programmes and algorithmic trading strategies can quickly erode liquidity and result in disorderly markets. Especially in times of significant volatility, like 6 May 2010, high trading volume is not necessarily a reliable indicator of market liquidity. A report from the Kauffman Foundation (Bradley and Litan, 2010), confirms not only the complexity of the event, but that of the current market structure as well. It noted that the Flash Crash was the first electronic market crash and claimed, contrary to the SEC report, that although HFT has dramatically increased in importance, it is not to blame for the equity market problems. Instead, the Kauffman Report argues that policy makers should pay far more attention to the increased importance of ETFs, which introduce systemic risk in the market while discouraging investor interest in public offerings. In sum, and considering

[21] "I recognise that there may be a variety of reasons for reduced participation in the equity markets, but the trend is troubling, particularly if concerns about equity market structure are playing even a small role in investor decision-making… Less than 50% of the buy-side respondents, for example, expressed confidence in the current market structure. When these professionals … express concern in the U.S. equity market structure, we must listen closely". (Schapiro, 2010).

[22] Chairperson Mary L. Schapiro's interpretation on the Flash Crash event. Examples of recent market glitches, problems confronted in the IPO of Facebook in May, Knight Capital Group's loss of USD 440 million owing to a software problem in August and the cancellation of orders for Kraft Foods Group shares in October 2012 (Reuters, 3 October 2012).

the findings of other studies, the impact of market structure, trading practices and new equity instruments is not always straightforward, and since certain trading practices require or benefit from certain market structures (such as dark pools and co-location), developments are also likely to be mutually reinforcing.

The Flash Crash has been followed by a number of other national initiatives, notably the UK Foresight Report on the future of computer trading in financial markets and the European Commission's proposal on MiFID, which address issues regarding electronic trading and dark pools. The Australian and Canadian securities commissions have also published consultation papers on the new market structure and are conducting reviews of the current regulatory framework.

3.3.2.1 Eroding incentives and investor confidence

Together with providing liquidity, price discovery is one of the important functions of a well-functioning equity market (O'Hara, 2003). Defined as the search for an equilibrium price (Schreiber and Schwartz, 1986), the price discovery process plays a central role in the allocation of equity capital. During the formation of an equilibrium price, the individual investor compares the relevant information, including publicly available company information and available market prices of equities, with his/her own idiosyncratic information. Differences in expectations compared to the available market price then serve as the basis for the investors' investment decisions, which in turn will influence the market price and the move to a new equilibrium price.

This key role of price discovery in the allocation of capital in secondary markets makes efficient and fair price formation critical; not only for efficiency, but also for investors' confidence in the integrity of the markets and their incentives to identify and invest in long-term performance. While recognising the usefulness of dark pools for executing large trade orders, both IOSCO (2011a) and the European Commission (2010), emphasised the regulatory concerns related to them, as they may ultimately affect the quality of price discovery.

Weaknesses in price discovery may also have a negative effect on secondary public offerings, since the functioning of the secondary

public offering markets relies on the efficiency of the price discovery process.

One reason why dark pools generate unequal access to market data is that they do not publicly display orders. To compensate for this, as required in the MiFID, for example, prices in the dark pools should be determined by reference to a widely published price generated by another system and regarded generally by market participants as a reliable reference price. However, as dark pools are getting larger and lit pools are shrinking in terms of trade, the question arises as to where the breaking point is for using prices in small lit pools as the reference for the majority of trading taking place in dark venues.

Equal access to accurate market information is also a problem in relation to HFT, since high frequency traders generally use dedicated data feeds that provide them with information before consolidated information is delivered to the public (Linton and O'Hara, 2011). Another important aspect of the HFT price discovery process relates to order cancellations. Today, more than 90% of the total trade orders are cancelled by high frequency traders immediately after they are placed.

It is claimed that the increasing complexity of equity markets and experienced market failures have undermined investor confidence. In addition to dark pools, the general fragmentation of equity markets also makes it harder and more expensive for market participants to monitor markets. It has also led to widespread criticism from individual investors and, according to some, resulted in pull backs from the equity market (Shapiro, 2010).

3.3.2.2 Crowding out of long-term investment

While the effects of HFT on market liquidity are still under discussion,[23] its contribution to short-termism is quite clear, at least in terms of the decrease in the average holding period of shares.

[23] Linton and O'Hara (2011) claim that as measured by bid/ask spreads and other metrics, the liquidity in markets has improved over the last decade. They also point out periodic illiquidity, as the speed of trading and interconnectedness of markets make it possible for high frequency traders to transmit disruptions almost instantaneously across markets. The US CFTC and SEC's joint report (2010) also pointed out the potential short-term liquidity problems caused by HFT, especially in times of significant volatility.

Krugman (2009) discussed HFT by underlining the social function of markets to efficiently allocate equity capital. He questions the role of high frequency traders in promoting this function by placing their orders one-thirtieth of a second faster than anyone else does.[24]

High frequency traders mainly base their trading on market information rather than analysis of corporate fundamentals and analyst research. Because of its rapid increase and dominance in the market, fewer resources are in aggregate spent on fundamental analysis of the long-term value creation potential of corporations. In addition, HFT requires expensive investments in technological infrastructure and human resources devoted to programming, which highlights the issue of a level playing field between high frequency traders and investors that do not have the possibility or need to invest in that technical and human capacity (IOSCO, 2011a). This is claimed to force institutional investors who consider themselves disadvantaged in the current market structure to leave the market or to adapt their trading strategies to HFT, which further diminishes the portion of equity investors with a long-term strategy supported by corporate fundamentals. As seen from Figure 3.1, institutional investors' share in the global equity market has fallen by 5% after 2008, but, there is no evidence that this decrease has been caused by new market structures and trading practices. The only indication is the outflow of equity capital from mutual funds in the United States after the Flash Crash (Schapiro, 2010).

3.3.2.3 Hampering the use of primary equity markets

Concerns have also been raised that new market structures and trading practices impact the willingness of new companies to enter public equity markets and as well as that of already listed companies to raise additional funds through secondary offerings. As discussed above, these concerns are partly based on the lack of reliable price discovery mechanisms.

Moreover, it is argued that high frequency traders pay less attention to small and growing firms, focusing their trading instead on

[24] "It's hard to imagine a better illustration than high-frequency trading. The stock market is supposed to allocate capital to its most productive uses, for example by helping companies with good ideas raise money. But it's hard to see how traders who place their orders one-thirtieth of a second faster than anyone else do anything to improve that social function." (Krugman, 2009)

the liquid shares of large corporations. When institutional investors follow this pattern, the shares of small companies face an illiquidity problem (Economist, 2009). Evidence from the United Kingdom confirms a decrease in that trading in small companies, which coincides with the increase in ETFs and HFT during the second half of the last decade (Friederich and Payne, 2011).

Also, ETFs are criticised for reducing the liquidity in the shares of small companies. The likelihood of ending up as part of an ETF, but with an illiquid stock, thus discourages new companies from entering the market (Bradley and Litan, 2010a). In addition, it is argued that the disappearance of a long-term focus in favour of short-term trading makes the use of analyst reports superfluous (particularly for smaller companies), increasing the risk of mispricing and further undermining the willingness of new companies to enter the public equity market (Doidge *et al.*, 2011).

4. Developments in Shareholder Monitoring and Engagement

In addition to influencing the conditions for access to and allocation of equity (as described in Parts II and III), the corporate governance framework also decides how shareholders can monitor and engage in the corporate decision-making process. The possibilities for such monitoring and engagement cover a vast number of means and issues, including the ability to sell the stock, which may signal dissatisfaction, as well as more direct ways of engagement, for example in shareholder meetings, through board representation or even a takeover.

All of these rights are given to shareholders under the assumption that they, as residual claimants, have a unique incentive to care and inform themselves about the long-term success of the enterprise. It is assumed that there is a direct link between the performance of the corporation and the shareholder's income. On these grounds, attention has not only been given to what rights shareholders actually have, but also to their ability – and even willingness – to exercise those rights.

In most OECD countries today, there are few objective obstacles for shareholders to exercise their rights. There are few restrictions on buying and selling stocks in listed companies, the quantity and

quality of corporate information is constantly growing and through information technology, the organisation of and participation in shareholder meetings has been greatly facilitated. This is manifested in relatively high participation ratios at shareholder meetings, even in countries with a predominantly dispersed ownership structure such as the Netherlands, the United Kingdom and the United States.

Instead, the corporate governance policy discussion has come to focus on the actual *quality* of shareholder monitoring and engagement, and questions whether today's shareholders actually have the incentives to use their rights in an informed way and thereby serve the long-term interest of the economy. To what extent do different categories of shareholders actually perform their fundamental role to bring new and independent information about corporate prospects to the market? Has the fundamental incentive for active and informed ownership – on which so much of the corporate governance doctrine rests – simply disappeared for large or dominant groups of shareholders?

The empirical basis for this question has little to do with the equity instrument itself. Instead, explanations are typically sought in a more complex chain of intermediary investors and the *incentives* that follow from the business models, competitive situation and investment strategies of institutional investors.

To shed some light on these questions, this part describes developments with respect to various means of shareholder participation in the corporate decision-making process together with some empirical evidence of how and to what extent shareholders participate in the decision-making process of the corporation. It also provides a discussion on the emergence of new categories of investors, how they exercise their shareholder functions and how their actions relate to the objectives of the ultimate beneficiaries.

4.1 Different types of shareholder monitoring

The European Commission's *Green Paper on Corporate Governance* (2011) defines shareholder engagement as actively monitoring companies, engaging in a dialogue with its management and using shareholder rights, including voting and co-operation with other shareholders, to improve the governance of the investee companies

in the interest of long-term value creation.[25] This approach provides a broad spectrum of shareholder means, from selling and buying shares to expressing their views on a large number of issues from board composition to major transactions and takeover bids (Gillan and Starks, 2007).

The basic legal and economic doctrine behind the *OECD Principles* is that shareholders have the incentives to obtain sufficient and reliable information about their investee companies so that they, in an informed fashion, can look after their own interests. This assumes that shareholders not only make rational use of any information that is disclosed by the company itself, but that they also – at some cost – gather information from other sources that are not necessarily public. This plurality in terms of information gathering and independent assessments about corporate prospects by a large number of different shareholders is the very basis for a well-functioning market economy, effective price formation and capital allocation. The information can be used either to trade the stock of a particular company or as the basis for influencing corporate practices through the corporate governance process.

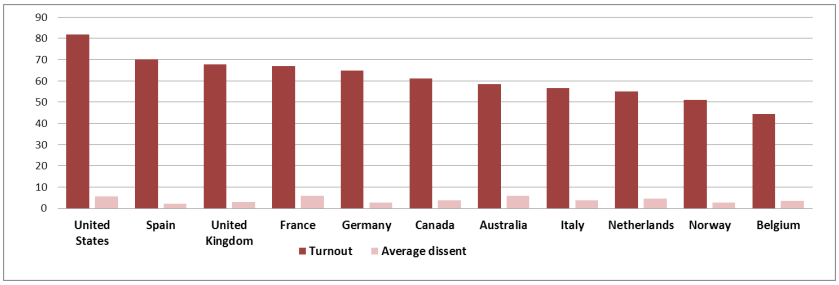
One way to measure the degree of shareholder monitoring and engagement is the participation and voting patterns at shareholder meetings. Figure 4.1 shows the average shareholder turnout and average level of dissent in shareholder meetings in some OECD countries. In line with other studies (Institutional Shareholder Services, 2011; European Parliament, 2009), it illustrates the relatively high level of shareholder participation. In all of the surveyed countries, turnout was above 50% of all issued shares. Notably, among the countries with the highest turnout are the United Kingdom and the United States, two countries with predominantly dispersed ownership at the corporate level. In the United Kingdom, the average turnout was almost 70% and in the United States it was no less

[25] The effectiveness and outcomes of shareholder engagement is also discussed. It is argued that shareholders of financial institutions sometimes encourage the financial institution to take excessive risks as they have a short-term investment horizon (European Commission, 2010). It is also argued that even if shareholders exercised their rights effectively, they would still not to do so to maximise shareholder wealth. This is explained by the market, political and social incentive-creating forces driving institutional investors to value things other than shareholder value, which arises from the conflict of interest between institutions (union, state agent, etc.) and shareholders (Camara, 2005).

than 80%. While we do not have access to data, turnout levels in many emerging market companies can be expected to be fairly high, primarily due to a relatively limited free float or otherwise concentrated ownership structure.[26]

Another measure of engagement is the the degree of dissent and the number of shareholder proposals that are tabled. Figure 4.1 shows that the degree of dissent is quite low among the surveyed countries, varying between 2-6%. One explanation could be that shareholders find management (or board) proposals to be well aligned with their own interests (Institutional Shareholder Services, 2011). However, it may raise questions about shareholders' awareness and conformity in opinions.

Figure 4.1. Shareholder turnout and average dissent, 2010 (%)



Note: Turnout is the percentage of the issued shares represented at the shareholder meeting. Dissent is the percentage of votes cast against the recommendation of company's management on a resolution.

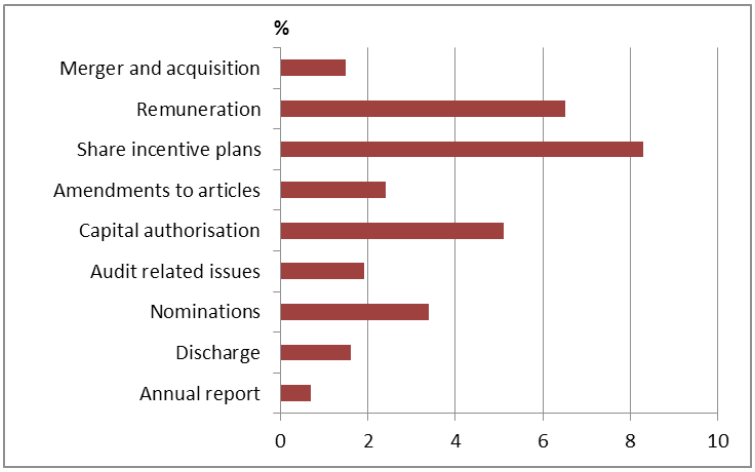
Source: Hewitt, P. (2011), "The Exercise of Shareholder Rights: Country Comparison of Turnout and Dissent", *OECD Corporate Governance Working Papers*, No. 3, OECD Publishing, doi: *10.1787/5kg54d0l1lvf-en*.

Even in the controversial case when the Royal Bank of Scotland and Fortis proposed a takeover of ABM Amro, which was subject to extensive and vivid public debate before the shareholder meeting, dissent among shareholders was only about 5%. The acquisition was generally considered as a failure and was followed by the bankruptcy and subsequent nationalisation of the two acquiring banks (OECD, 2009). Another indication of the degree of discretion in shareholder voting is provided in Cai et al. (2009), which found that for board elections in the United States, even for underperforming directors

[26] With limited data availability, Hewitt's (2011) study also indicates a high turnover in some emerging markets, such as Brazil (77%), Turkey (69%) and Poland (66%).

and companies, almost 94% of votes were cast in favour of the proposed candidates.

Figure 4.2. Average dissent in Europe, 2010



Source: Institutional Shareholder Services (2011), *Voting Results Report: Europe*, ISS, available at: *www.issgovernance.com/files/private/VotingResultsReportEurope2011.pdf*.

As shown in Figure 4.2, on average, remuneration policies and the introduction of share incentive plans received the largest number of dissent votes in Europe in 2010, while dissent votes for issues related to mergers and acquisitions were much lower. One explanation could be that both remuneration proposals and share incentive plans typically include a fairly direct element of current or future pay-outs and share dilutions, whereas the consequences of mergers and acquisitions are harder to foresee and require much more time and resources to analyse.

An even less common expression of shareholder engagement is to propose a resolution to a shareholder meeting (Hewitt, 2011). Again, one explanation may be that they may require substantial time and resources to prepare and pursue. Also, experience has shown that resoutions are most often unsuccessful and may send negative signals to the market about the performance or the governance of the company, which in turn could result in a negative reaction of the stock market (European Parliament, 2009).

A study by Van der Elst (2011) of five European countries[27] found that ownership concentration increased the overall voting turnout while financial performance does not have any effect on the level of participation. He also found that the presence of director elections on the agenda was positively correlated to shareholder turnout. A report by the European Parliament (2009) confirmed that the average attendance level is significantly higher in companies with a controlling owner. The report also claimed that smaller shareholders seem to abstain from participating in the shareholder meeting when there is a non-controlling large shareholder. This behaviour can perhaps be explained by a sentiment among shareholders that their voices will not be heard. It can also be interpreted as a sign of confidence that the large non-controlling owner has the incentives and capacity to perform the monitoring function of management on behalf of the smaller shareholders.

An important explanation for the high turnout, particularly in the United Kingdom and the United States, is the use of proxy voting.[28] In both countries, proxy voting has become the principal way in which shareholders exercise their voting rights: voting occurs almost entirely by the use of proxies that are solicited before the meeting (SEC, 2010b). With the help of information technology, proxy voting is not only a cost-effective means for shareholder participation, the process of solicitation is also a means to influence decisions and verify the outcome before the formal shareholder meeting.

A less formal way of monitoring is through dialogue with the board or the management of the company. In a survey by IRRC and ISS (2011), more than half of the asset owners, asset managers and issuers reported such engagement activity in 2010. The engagement practices vary from campaigns to persuade a company to change its behaviour to a routine email exchange or telephone call. It is worth noting that that 76% of asset owners and 56% of asset managers stated that they had five or less staff members devoted to engage-

[27] Belgium, France, Germany, the Netherlands and the United Kingdom.

[28] In addition to companies and shareholders, the proxy system involves brokers, banks, custodians, depositories, transfer agents, proxy solicitors, proxy service providers, proxy advisers and vote tabulators. Basically, shareholders cast their votes through intermediaries who use a proxy service provider to collect and send the votes to the vote tabulator (SEC, 2010b).

ment with investee companies. This number should be related to the hundreds or perhaps thousands of companies that these institutions may hold in their portfolios. Against this background, it is not surprising that limited staff was identified to be the main impediment to engagement.

An *ex-post* form of monitoring is shareholder suits. According to Securities Class Action Clearinghouse data, nearly 200 class action lawsuits were filed annually between 1997 and 2011 in the United States.[29] While it is argued that the vast majority of shareholder suits settle without a trial (Black et al., 2006), this does not make them less efficient in terms of shareholder engagement. Depending on the legal framework, ownership structure and investment culture, the role of lawsuits as a way of engaging shareholders varies across countries. A study by Girard (2009) on French shareholder activism between 1989 and 2008 found that although shareholder activism was limited compared to the United States and the United Kingdom, lawsuits do play an important role. In nearly 50% of the total shareholder activism cases (100 out of 203) identified in the study, a lawsuit was part of the process. Suitors were often investors associations.

Vermeulen and Zetzsche (2010) studied shareholder suits in the Netherlands and in Germany. In the Netherlands, out of 23 inquiry requests with respect to public companies, an injunctive relief was requested in 21 cases and preliminary remedy was granted in 12 (57%). Preliminary remedies included the appointment of independent directors, the prohibition of voting on particular agenda items and deviation from the articles of association. The company and its shareholders mostly followed the preliminary relief and reached a settlement. In Germany, they found that every year approximately 12% of all companies whose shares are traded on the stock market were subject to a recession suit regarding their shareholder meetings.[30] In this process, any shareholder can initiate a court proceeding against the result of a shareholder meeting without a precondi-

[29] Stanford Law School Securities Class Action Clearinghouse, *http://securities.stanford.edu/litigation_activity.html*.

[30] There is a risk of double counting in this calculation as one issuer may be subject to more than one suit if an extraordinary shareholder meeting is held (Vermeulen and Zetzsche, 2010).

tion to have a personal interest. Essentially shareholders contested on their own, even sometimes with a few shares.

4.2 Different ownership categories and monitoring

In the introduction to this part we pointed to the fundamental economic rationale for providing shareholders with the means to monitor and engage and proposed that at the heart of this doctrine is the assumption that there is a direct link between corporate performance and the shareholder's income. Other parts of this report concluded, however, that this direct link is broken by an increasingly complex universe of intermediaries whose business is to manage other people's money. As a consequence, the ownership community is far from homogenous in terms of their incentives to monitor corporate performance. It is worth illustrating the consequences of this using a very simplified arithmetic example:

Consider a company owned by 1 000 profit-maximising funds that all manage their client's money for a fixed fee and hold similar and pre-defined indexed portfolios. One of the funds has the possibility to pay EUR 50 for a set of unique information on how to improve the company's performance by EUR 100 000. If this information is conveyed and used by the company, all funds will gain EUR 100. However, the net gain for the "engaged" fund is only EUR 50, since it also invested EUR 50 in obtaining the performance-enhancing information. As a consequence, at the end of the year, the fund will show a lower net rate of return on its portfolio than all of its competitors, and if savers can move their money without the costs being too high, will go out of business. It will also return lower profits to its owner, which, in principle, could be compensated by increasing the fees that it charges its clients; an option that does not seem viable considering that the fund's track record shows underperformance in relation to its competitors. Hence, we are left in a situation where the socially optimal behaviour of engagement that improves corporate performance and creates additional value for society drives the "engaged fund" out of business. In this simplified example, the "production" of socially valuable information will not take place.

The outcome in this example has nothing to do with the classical Berle & Means problem of dispersed (or atomized) ownership,

where the gross cost of engagement for a very large number of very small owners does not correspond to the net gains. Instead, it is driven by assumptions regarding the business model, competitive environment and investment practices of the intermediary investors.

Again, the example is simplified. But as a framework for analysing shareholder behaviour and engagement, it has practical relevance. In almost every case of intermediation, an adapted version of this analytical approach can be applied to predict behaviour by identifying the business model, competitive environment and investment practices for different categories of owners and the incentives that follow. It also points to the important conclusion that genuine and informed shareholder engagement that improves corporate performance is closely related to the individual shareholder's possibility to internalise or privately appropriate the returns on his investment in research and information.

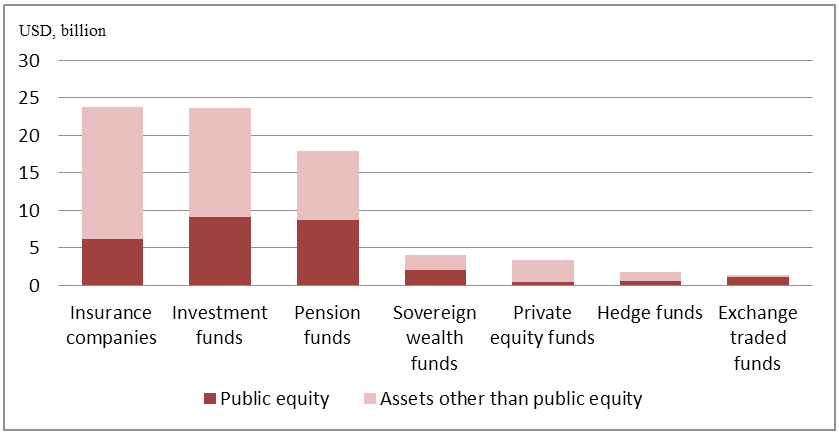
For some non-commercial institutional investors, for example public pension funds, the incentives for engagement may again be different. For such investors, and depending on their institutional structure, the analysis of their incentives and objectives for corporate activism may (for example) benefit from experiences with public choice theory and how bureaucrats and political appointees responsible for the fund's investment may maximise their own personal and political preferences rather than the benefits to the ultimate beneficiaries, such as current and future retirees.

As discussed in Part III, most OECD countries have seen a marked shift from direct ownership to intermediary ownership over the last few decades. As we will discuss below, the universe of intermediaries has also become more complex. Today we see a mix of "traditional" institutional intermediaries, such as pension funds and insurance companies, alongside "alternative" institutional investors, such as hedge funds, sovereign wealth funds and private equity firms. Furthermore, the different categories may, within themselves, carry out similar functions, for example asset management services.

Partly as a result of this complexity, data on different categories of institutional investors' portfolio allocations and investment strategies is limited. A rough overview is provided in Figure 4.3, which shows that while "traditional institutional investors" (pension funds, mutual funds and insurance companies) hold the absolute

lion's share of public equities, about USD 4 trillion (7%) of publicly traded equity is held by other "institutions", all with their own business models and incentives for monitoring and engagement.

Figure 4.3. Institutional investors' allocation to public equities (2011)



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

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

4.2.1 Pension funds, mutual funds and insurance companies

Today, "traditional" institutional investors (pension funds, mutual funds and insurance companies) hold nearly half of the listed equities in the world, but there is no available data that identifies the participation of different categories of investors in shareholder meetings. Nevertheless, considering the generally high turnout at shareholder meetings and the low participation by individual shareholders, it can be assumed that institutional owners typically participate in shareholder meetings. This assumption is particularly strong for the United States and the United Kingdom, where turnout levels are very high and institutional owners hold nearly 70% of the listed equities.[31]

[31] On the other hand, some surveys (Dutch Corporate Governance Code Monitoring Committee, 2011) show that a large majority of institutional investors make use of the voting advice of third parties, which can be seen as a sign of their participation in the shareholder meetings.

A study by Institutional Shareholder Services (2010) on European listed companies, which was based on the assumption that all shareholders holding more than 5% of the issued share capital exercise their voting rights, found that, with the exception of the United Kingdom, the majority of the remaining smaller shareholders do not participate in the meetings. In some cases, such as Belgium and Italy, participation among shareholders with less than 5% of the shares was under 20%.

The low participation by individual shareholders is confirmed by their low participation in the general proxy voting process. The SEC (2010b) notes that broker-dealers have estimated that only 20-30% of their individual customers usually vote.

The principal means of shareholder participation by pension funds, mutual funds and insurance companies is through proxy voting. That is why over the last decade they have substantially increased their use of so-called proxy advisors (SEC, 2010b); a practice that has also grown in Europe. A survey conducted by the Dutch Corporate Governance Code Monitoring Committee (2011) found that 88% of institutional investors in the Netherlands made use of the voting advice from third parties.[32]

An important driver behind the use of proxy advisors is regulatory requirements for some institutional investors to vote their shares. Voting thousands of shares can be a costly exercise and to rationalise the procedures it is routinely contracted out. As the director of proxy voting services at Wells Fargo expressed it: "*since we invest by formula, we vote by formula*" (Lowenstein, 1991). The ERISA Act of 1974 and interpretive bulletins in the United States were of particular importance for the creation of this market for proxy services. These were was soon followed by the establishment of proxy advisory firms, such as the Institutional Shareholder Services (ISS) in 1985.

While there is no requirement under the ERISA Act to disclose overall voting policies with respect to a pension fund's investments,[33] it has been claimed that pension plans and mutual funds have considered it mandatory to vote their shares under the act and

[32] 22 out of 25 institutional investors.

[33] US response to the OECD questionnaire on the role of institutional investors in promoting good corporate governance.

the Department of Labor's interpretive guidance to the act (Hewitt, 2011).

In addition to the effects of direct regulatory demands, it has also been argued that changes in board structures and board election processes have further increased the demand for proxy advisory services. In the United States, most listed companies have shifted from plurality voting to majority voting, which requires that a nominee for board membership receive a majority of the votes cast. Moreover, many companies have abandoned the practice of staggered boards, which declined from 55% in 2005 to 40% in 2007 among S&P 500 companies. The NYSE has adopted a rule which bans brokers from voting without instructions from beneficial owners on director elections (Choi et al., 2010).[34]

The business of proxy advisors is to sell recommendations to institutional investors on how to vote and to sell services that help with the actual process of exercising the voting rights. They also sell corporate governance related consulting services to corporations and undertake so-called corporate governance ratings of these companies. Concerns have been raised about a potential conflict of interest, as proxy advisors sell recommendations to shareholders about corporate governance practices in corporations to which they sell consulting services (SEC, 2010b).

Concerns have also been raised about market concentration in the proxy advisory industry, with a few firms having a large share of the market without appropriate oversight or actual economic interest in the long-term value of the companies (OECD, 2010; European Securities and Market Authority, 2012; SEC, 2010b). The largest proxy advisory firm, ISS, claims to serve over 1 700 institutional clients, including 24 of the top 25 mutual funds, 25 of the top 25 asset managers and 17 of the top 25 public pension funds (Daines et al., 2010). According to its website, ISS covers more than 40 000 shareholder meetings in over 100 developed and emerging markets worldwide with a team of 600 experts, including research, technol-

[34] The discretionary broker votes are estimated to be about 19% of the votes cast in the shareholder meetings in the United States and are mainly supportive of management's proposals. Interestingly, if the rule had been in effect during Citigroup's 2009 shareholder meeting, two of the group's nominees would not have been elected, as broker votes were 46% of the total votes cast (Choi et al., 2010).

ogy and client service professionals. Very simply put, this means that each employee is responsible for researching almost 70 shareholder meetings (companies) a year in order to develop voting advice on a vast number of complex issues that are up for decision.

There are also important questions about the quality of proxy advisors' analytical methods and criticism that it does not take company- and country-specific characteristics into account (European Commission, 2011), but rather adopts a mechanical and potentially box-ticking approach in its analysis (European Securities and Market Authority, 2012).

The influence and efficiency of proxy advisory firms are attracting growing interest from researchers. A study of Cai et al. (2009) addressed the influence of a proxy advisor's recommendation on the election of a board member and found that the nominees who received a negative recommendation from ISS received 19% fewer votes compared to other candidates. Another study by Daines et al. (2010), which examined the corporate governance rating activities of proxy advisors, concluded that despite claiming the contrary, these firms have limited or no success in predicting company performance or other outcomes of interest to shareholders. In fact, the study showed a negative correlation between the corporate governance index of Risk Metrics and the value of the company as measured by Tobin's Q. They also found a negative correlation between corporate governance ranking and corporate performance. These results are largely confirmed in a study by Bebchuck and Hirst (2009), which emphasised the need to take differences in ownership structure into account when assessing the quality of corporate governance in individual companies.

In light of a growing discussion about the role of proxy advisors, the French securities regulator, AMF, has published a recommendation on proxy advisors and the United States' SEC and the European Securities and Market Authority (ESMA) have published consultation papers on the proxy advisory industry.[35]

[35] Autorité des marché financiers (2011); SEC (2010b); European Securities and Market Authority (2012).

4.2.2 Alternative institutional investors

The total assets under management of what we here call "alternative" institutional investors (hedge funds, private equity funds and sovereign wealth funds), is relatively small compared to the combined holdings of "traditional" institutions, defined as pension funds, mutual funds and insurance companies. While the exact numbers are hard to come by, the estimated holdings of "traditional" institutions are about USD 65 trillion, whereas "alternative" investors hold around USD 8.8 trillion.[36] As a group, the "alternative" investors hold a smaller part of their assets in publicly traded equity. Sovereign wealth funds have the largest allocation in their portfolios to public equity, while private equity firms have the smallest.

Despite their relatively modest investment in public equity, hedge funds and private equity funds have featured prominently in the public discussion about shareholder activism and have by some commentators been seen to hold great promise as active shareholders in the absence of "traditional" institutional investors (Kahan and Rock, 2007). Particularly before the financial crisis, activist hedge funds and private equity firms were often seen as the representatives of an increasing demand for a voice in corporate governance. While they noted that private equity funds and hedge funds are very seldom large shareholders in European listed companies, in 2007 the European Parliament (2007) pointed to their growing role as active shareholders. The OECD described their business model as seeking to increase the market value of their capital through active engagement with individual public companies from which they demand changes in management, the composition of the board, dividend policies and company strategy (OECD, 2007a).

An important difference compared to "traditional" institutional investors who typically charge a fixed fee on assets under management is that hedge funds and private equity funds typically charge various forms of performance-related fees. It has been claimed that this remuneration system creates greater incentives to pursue activist investment strategies (European Parliament, 2009).

[36] The total assets under management are estimated to be USD 8.8 trillion, of which: hedge funds, USD 1.8 trillion; private equity funds, USD 3 trillion; and sovereign wealth funds, USD 4 trillion. (Sources: IMF, 2011; Preqin, 2011).

While their interest in shareholder voice may be similar, the strategies of hedge funds and private equity firms to provoke change are quite different. Hedge funds usually influence public corporations through small, non-controlling holdings. By using derivatives and other financial techniques such as share lending, they partly rely on other investors, including "traditional" institutions, to increase their potential voting power to influence change (OECD, 2007a). These techniques have raised concerns that activist hedge fund strategies favour short-term profits rather than long-term value creation (European Parliament, 2009). It is argued that they do not have an incentive to focus on the long-term success of the companies whose stock they hold, as there are strong links between their short-term performance and ability to raise additional funds (Anabtawi, 2005).

Private equity firms, on the other hand, typically acquire large or controlling shares of companies that are suited for a (leveraged) buyout and delisting. The differences in techniques also indicate a difference in time horizon, as private equity funds have a longer horizon than activist hedge funds (Achleitner et al., 2010). Unlike hedge funds, which may immediately realise the gains from their interventions through the use of derivatives and other instruments, the full gains to private equity funds only occur after restructuring and sale of the company. This sale can be either to another private equity firm, a company, a strategic investor or the general public through an IPO (McCahery and Vermeulen, 2008).

A third category of "alternative" institutional investors consists of what is often labelled sovereign wealth funds (SWFs). Like almost all of the different categories of institutional investors, this is also quite a heterogeneous group, varying from fiscal stabilisation funds to investment corporations and pension reserve funds without explicit pension liabilities. In some cases they also serve as central ownership agencies of state-owned assets, but may at the same time hold portfolio investments in publicly listed companies.[37] In the *Santiago Principles* (2008), they are simply defined as special purpose investment funds that are owned by the general government.

[37] For example, in Saudi Arabia the SWF holds 36% of the total market capitalisation (Markaz, 2008), more than 80% of which is non-free float controlling shares of some large listed SOEs (SABIC, Saudi Telecom and Saudi Electricity Company).

Unlike activist hedge funds and private equity funds, SWFs usually follow passive investment strategies in terms of portfolio investments. As a consequence, the debate about their ownership role is not primarily related to shareholder activism, but rather to concerns about political interference, protectionism and their own transparency and accountability (Blundell-Wignall et al., 2008).

The fastest growing category of "alternative" institutional investors in recent years is exchange-traded funds (ETF), which have become a significant component of passive investment strategies. ETFs cater to the demand for passive, indexed investment strategies and as such do not have incentives to exercise any shareholder rights that come with their holdings. This is amply manifested by the fact that some ETFs, instead of charging management fees, rely totally on proceeds from securities lending to generate income (Wong, 2010).

With a dramatic surge in HFT, a special "category" of owners in the form of proprietary traders has attracted increasing public attention. Proprietary traders are not a special category in the sense of legal form or business model, but a practice carried out by a wide range of institutions. In the Dodd-Frank Act, proprietary trading is referred to as engaging as a principal for the trading account of the corporation in any transaction to purchase or sell equities and other financial instruments. The practice is mainly carried out by independent HFT firms, hedge funds and the proprietary trading desks of investment banks. It is estimated that proprietary trading accounts for 10% of Goldman Sachs' revenues and less than 5% of Morgan Stanley's and Citibank's (Wall Street Journal, 2010). Crotty et al. (2010) argue that there is strong evidence that these figures underestimate the importance of proprietary trading. However, available data is limited.

As mentioned in Part III, there is also a lack of reliable data concerning the actual shareholdings of high frequency traders, but it is generally estimated that their direct shareholdings are very small in relation to their trading volume. In the United States, for example, banks and other financial institutions hold only about 1% of listed stocks.

The debate on their role in the financial crisis was not primarily related to their role as shareholders, but rather to their portion of the trading volume in derivate and debt instruments. The Flash

Crash in May 2010 set off the discussion about their impact on public equity markets. The so-called Volcker Rule, which was expected to be implemented in July 2012 as part of the Dodd-Frank Act, includes prohibitions and restrictions on the ability of a banking entity and non-bank financial company to engage in proprietary trading. However, it is claimed that firms would continue proprietary trading in different formats, such as indirect ownership of trading firms (Wall Street Journal, 2012). It is also worth mentioning that the rule does not cover all investors engaging in proprietary trading, for example hedge funds and specialised HFT firms.

An important characteristic of proprietary traders, compared to other institutional investors, is that they are not intermediary investors. Instead, they invest on their own behalf and in their own name. This makes them similar to hedge funds. As mentioned above, some hedge funds also engage in proprietary trading. Proprietary trading is closely linked to HFT and to a large extent driven by technological advancements in computer capacity and privileged access to market information. Since the trading strategy has a very short-term focus based on arbitrage opportunities, it does not require any engagement with the investee company.

4.3 Obstacles to monitoring

As mentioned in the introduction to this part, the last couple of decades have seen major improvements in the conditions for shareholders to participate in shareholder meetings. For a select number of countries, participation rates are indeed relatively high. Today, the discussion on regulatory obstacles to shareholder participation is mainly focused on shareholder co-operation and cross-border voting.[38]

In terms of co-operation among shareholders, one source of concern has been that national regulations do not clearly define the boundaries for collaboration among investors, or acting in concert. The claim is that unclarity makes institutional investors reluctant or unduly cautious to co-operate on corporate governance matters

[38] In some jurisdictions there are also important discussions about the fact that most shareholder meetings take place during a very limited time period, there are restrictions on putting an item on the agenda, procedures for convening the meeting and difficulty in accessing meeting documents.

(OECD, 2010). An initiative to remove such concerns and bring greater clarity was taken by the UK Financial Services Authority[39] and the UK Takeover Panel (2009). In 2009, they issued public statements that their regulatory frameworks do not prevent institutional investors from co-operating or undertaking collective action. The European Union has also launched an initiative to increase legal certainty on the relationship between co-operation among investors and the rules for shareholders that are acting in concert (European Commission, 2012). Co-operation obviously requires the ability to identify other shareholders. To facilitate this, the European Commission's Corporate Governance Action Plan (2012) proposes an initiative that would improve the visibility of shareholdings in Europe.

Potential obstacles to cross-border voting have announced themselves in the wake of increased globalisation of share ownership. Today, the share of listed equities held by foreign investors is over 40% in the United Kingdom, over 25% in Japan and around 15% in the United States. It is argued that cross-border voting is still difficult in many jurisdictions and that even within the single market of the European Union, there are important obstacles (European Commission, 2010).

In some countries, there are also regulatory restrictions on the maximum size of institutional investors' equity ownership in a single company. It could be argued that these limitations restrict their ability to take large ownership stakes in individual companies. This may indeed be true in some cases, but in practice, and since many of the institutions pursue an index strategy, their holdings in individual companies is typically far smaller than the required maximum limit.

4.4 Shareholder incentives for monitoring

While some obstacles may remain, there is a general consensus that shareholder rights in OECD countries have been substantially strengthened in the last decades and that there is a general trend to empower the shareholder meeting in the corporate decision-mak-

[39] An open letter from the Financial Services Authority to the Institutional Shareholders' Committee, 19 August 2009, *www.frc.org.uk/FRC/media/Documents/shareholder_engagement_FSA_letter.pdf*.

ing process, particularly with respect to board nomination and remuneration policies. Nevertheless, the OECD's analysis of the financial crisis (OECD, 2010) concluded that "*shareholders have been largely passive and reactionary in exercising their rights, in many cases voting in a mechanical manner relying on proxy voting advisers and generally failing to challenge boards in sufficient number to make a difference.*"

As concluded in the introduction to this part, the degree and quality of shareholder engagement can mainly be explained by *understanding the incentives* for their engagement that follows from the business model, the competition environment and the investment strategies of the institutional shareholders. Today, many shareholders are themselves profit-maximising corporations acting in highly competitive markets where their main income is the fees that they charge for capital under management. This, together with the challenge to meet the market, has often led to investment strategies based on broad indices that may include holdings in hundreds, and often thousands, of companies.

The widespread use of indexing, with small holdings in a very large number of companies, obviously increases the total costs of engagement with portfolio companies. It also decreases the incentives to do so, either for competitive reasons as explained in the introduction to this part, or through the mere fact that the absolute expected returns from engagement are too small relative to the costs that are associated with informed monitoring and engagement.

In light of this development and the experiences from the financial crisis, a number of initiatives have been taken to overcome what is often seen as a *passive, reactive and mechanical* attitude to shareholder engagement among institutional investors. The most prominent example is probably the UK Stewardship Code.

For such codes or recommendations to be effective, however, it is necessary to understand the intrinsic incentives for engagement among the many different kinds of institutional investors. It is not adequate to refer to "institutional investors" in general. As we have shown, institutional investors is a concept that covers a very diverse group of entities and legal forms, ranging from public pension funds and mutual funds to hedge funds and investment banks, each with its own business models, profit-maximising objectives and competitive circumstances that will influence its investment strategies' trading practices and its incentives for monitoring and engagement.

Moreover, the actual management of the equity portfolio is (like voting) often outsourced to specialised service providers. This makes the ownership landscape increasingly complex and often decreases the precision of any generic regulation or recommendations with respect to stewardship. Particular interest has been given to the concept of so-called fiduciary duty, which is discussed in some detail below.

In order to design effective regulation or recommendations with respect to shareholder monitoring and engagement, it would be useful to first have a detailed understanding of the different business models, competitive circumstances and investment strategies of the many different institutional investors, and the resulting incentives.

4.4.1 The concept of fiduciary duty

When the *OECD Principles* address the role of institutional investors in corporate governance, they are focused on the responsibilities of institutional investors that invest in their own name and have a fiduciary duty to the ultimate beneficiaries. The fiduciary concept for institutional owners generically means that the institutions shall serve the interest of the beneficiaries, rather than their own immediate interest. A common and implicit interpretation of this fiduciary duty is that institutions should monitor and engage with investee companies.

It is important to understand, however, that a fiduciary obligation in itself does not imply any particular investment strategy or any specific degree of governance engagement by the institutional investor. If the fiduciary duty is generically defined as maximising the financial returns to the ultimate beneficiary, and if engagement costs exceed the engagement benefits, the way to meet the fiduciary duty obligation may in current equity markets very well be to invest in expensive computer capacity and engage in algorithmic HFT. Meeting the fiduciary duty may not even – again, depending on the context – imply any obligation to vote the stocks of portfolio companies. When voting costs are high and returns are low, it is mainly an empirical matter, what strategy and type of engagement (if any) best serves the institution's ultimate beneficiaries.

Of particular interest has been the outsourcing of asset management and governance functions to independent asset managers,

which, according to some commentators, has made the interpretation of fiduciary duties in the investment industry increasingly dysfunctional (FairPensions, 2012), particularly if asset managers do not consider themselves as fiduciaries (Financial Times, 2012)[40] but rather as a specialised service provider.

Globally, independent asset management firms are estimated to have more than USD 32 trillion under management, including assets managed on behalf of mutual funds, pension funds and private investors. This amounts to almost half of total assets held by the investment industry and points to the scale of outsourcing from traditional institutions (TheCityUK, 2012). The asset management industry is not only large, it is also quite profitable. In 2011, the pre-tax profit margins in the United States' asset management industry was an impressive 28% (McKinsey, 2012). In the United Kingdom, it was even higher, amounting to 34% of revenues (TheCityUK, 2012). As a comparison, the average pre-tax corporate profit margins (including the financial industry) globally in 2010 were estimated at less than 17% (BlackRock, 2011).

Considering the magnitude of outsourcing to asset managers, the UK Stewardship Code's definition of institutional investor also includes asset managers, with a day-to-day responsibility of managing investments on behalf of other institutions, such as pension funds. While noting that the stewardship responsibilities of asset owners may be different from asset managers, the UK Stewardship Code defines institutional investors' main duty to act in the interests of their clients or beneficiaries.

The *Kay Review* also addressed the importance of asset managers and the potential conflicts of interest that arise from the differences in business models between asset managers, institutional asset owners and their ultimate beneficiaries. In a report by the European Commission (2010), it is argued that performance evaluation structures for asset managers, and therefore compensation structures, contribute to a short-termism in equity markets. Many asset managers are selected and compensated based on short-term performance, which naturally encourages them to have a short-term focus, while

[40] UK FSA Chairman: "In some of my meetings with portfolio managers I have been surprised to see how little interest they have shown in vital issues like strategy and risk management."

the liabilities of the asset owners that pay for their services are often long-term.

Beyond the "traditional" institutional investors, there are also a number of institutions for which the concept of fiduciary duty and beneficial owner are ambiguous or absent. One example is private equity firms, where the general partner and investment advisor co-invest with the limited partners for a contractually agreed remuneration that is based on both capital under management and performance. Similar issues concerning the concept of fiduciary duties may also arise for hedge funds.

In general, it is not evident that reliance on fiduciary obligations in itself will have a positive impact on the degree and quality of monitoring and engagement by institutional investors.

4.4.2 The "market" for shareholder co-operation

Another avenue to improve institutional investors' engagement has been to encourage or facilitate their co-operation. Most "traditional" institutional investors diversify their portfolios and the active monitoring of many thousands of portfolio companies becomes excessively expensive.

The *OECD Principles* and many national frameworks point to co-operation among institutional investors as a way to resolve this problem. The *OECD Principles* state that institutional investors should be allowed, and even encouraged, to co-operate when they take action to improve corporate governance in investee companies.

The question arises, however, how such co-operation is carried out in practice. There are certainly examples of co-operation between investors that may be driven by specific events, for example, a major takeover or a merger; situations that can lead to discussions and solicitations where institutions exchange different elements of information, assessments and perspectives.

The most common form of co-operation, however, seems to be based on a "market" solution based on outsourcing and driven by cost sharing, where institutions either set up their own joint advi-

sory functions or make use of independent commercial service providers, such as proxy advisors.[41]

While the demand for such services in some cases may be genuine, it is also driven by regulatory requirements or informal expectations. If regulation requires institutions to vote their shares who otherwise would not do so, a logical response from the institution would be to minimise the cost by sharing it with other like-minded institutions through an external service provider. Likewise, if co-operation is encouraged or expected, using a common co-ordinating and advisory body seems like a plausible and efficient way to share the costs of co-ordination.

The question, however, is whether these outcomes achieve what the regulation or recommendations actually aimed for, namely to strengthen the independent and pluralistic monitoring of corporate performance, which is so important for a well-functioning stock market. This debate has been most salient with respect to proxy advisors. As described in Section 4.2.1, the proxy advisory industry is highly concentrated, which may lead to herd behaviour in terms of voting, rather than the market-driven diversity of independent assessments and opinions that is so important for a well-functioning economy. Questions have also been raised with regard to the quality of the analytical models that are used and the correlation between the commercial corporate governance ratings and firm performance (European Commission, 2011; ESMA, 2012).

From a regulatory perspective, it would be important to analyse the effects of these "market" solutions to regulatory requirements and voluntary initiatives. It would be of particular interest to analyse if they are compatible with the original intention of regulations, codes or guidelines with respect to informed, value-adding and engaged participation through shareholder voting and co-operation among institutional investors.

[41] Around the world, there are many examples of industry initiatives to share the cost of monitoring and voting by establishing private associations to undertake background research and provide voting services. For instance, the Australian Council of Superannuation Investors (ACSI), which provides research and advice to its institutional investor members in material corporate governance issues, also provides services on local and international voting. The Ethos in Switzerland, a foundation of institutional investors, owns a company which provides proxy voting and company dialogue services to its members.

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Institutional Investors as Owners

Who are they and what do they do?

*Serdar Çelik and Mats Isaksson**

1. Summary, Conclusions and Policy Implications

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

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

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

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standardized advice on how to vote and help with the actual process of exercising voting rights.

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

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

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

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

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

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

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

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

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

2. The Institutional Investor Landscape

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

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

While the picture will become even more complex in parts III and IV of this paper, just the simple fact that institutions are legal rather than physical persons is an important observation with implications for corporate governance. Primarily because it creates at least one additional step in the link between the income of the ultimate provider of money (typically a household) and the performance of the corporation. The fact that institutional investors come in a great variety of forms also suggests that they will differ in terms of the

character and degree of ownership engagement. As the importance of institutional investors as owners of public equity has increased, so has the need to understand who they are and what role they play as shareholders. In this part we will therefore provide an overview of who the large institutions are, their relative importance in terms of assets under management and what they own.

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

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

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

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

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

fact that the UK Stewardship Code recently included asset managers in their definition of institutional investors.[4]

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

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

Being aware of existing shortcomings, Figure 1 illustrates the total assets under management of different types of institutional investors and the portion of these assets that they have allocated to public equities. The figure shows that in 2011, the combined holdings of all institutions represented was USD 84.8 trillion. Out of

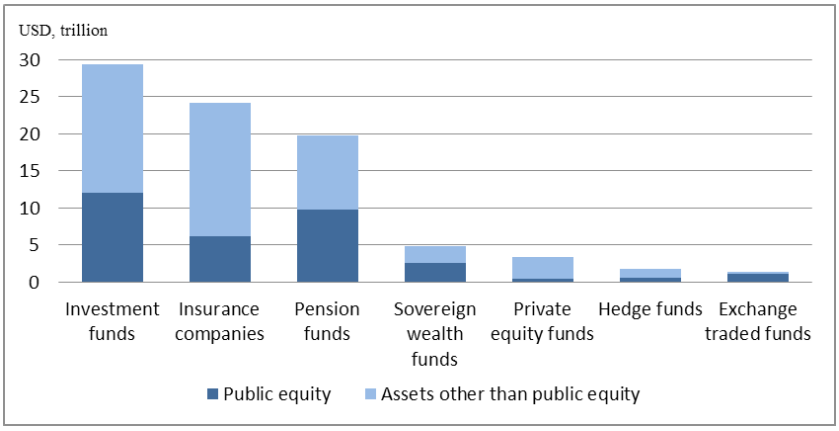
[4] The 2012 revision of the UK Stewardship Code includes a classification of institutional investors as asset owners and as asset managers. According to the Code asset owners are the providers of capital including pension funds, insurance companies, investment trusts and other collective investment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

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

this, 38% (USD 32 trillion) was held in the form of public equity. The largest institutions by far were investment funds[6], insurance companies and pension funds. Together they managed assets with a total value of USD 73.4 trillion of which USD 28 trillion was held in public equity. Alternative institutional investors as a group, represented by sovereign wealth funds, private equity funds, hedge funds and exchange traded funds were estimated to hold total assets of USD 11.4 trillion, of which 40% (USD 4.6 trillion) was invested in public equity.

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

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



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

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

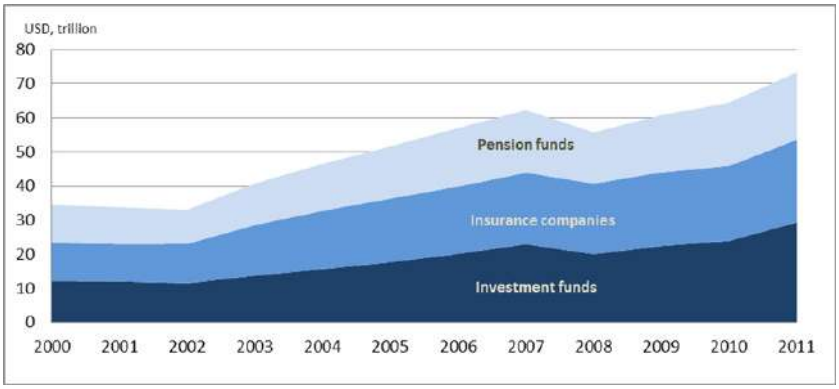
[6] Investment funds include mutual funds and other investment funds. In some countries, "collective investment schemes" is used to refer investment funds.

2.1 "Traditional" institutional investors

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

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

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



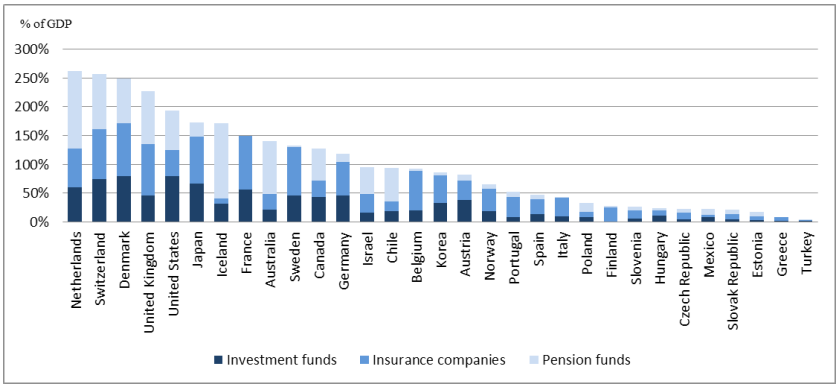
Note: Since insurance companies and pension funds invest in mutual funds, investments funds data also include pension funds' and insurance companies' assets.

Source: OECD Institutional Investors Database.

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

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

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



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

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

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

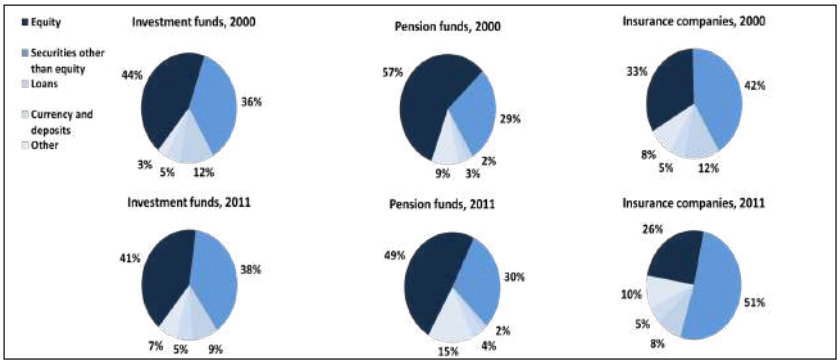
ment funds. Insurance companies held 26% of their assets in the form of public equity.

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

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

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

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

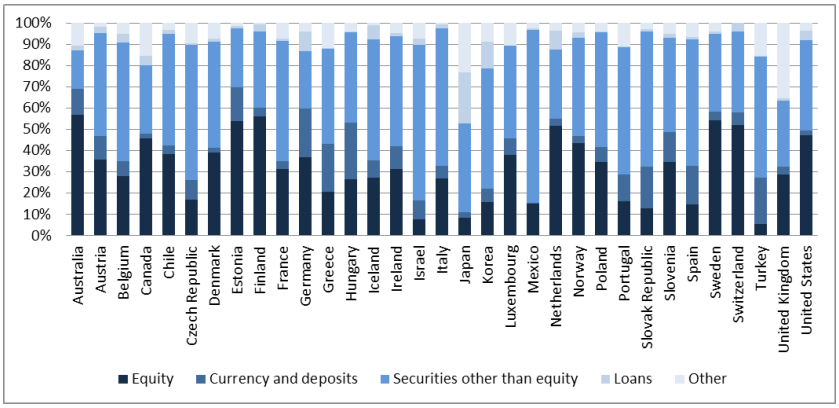


Note: Other category includes investments in private equity, venture capital, hedge funds, real estate, commodities, commercial loans, financial derivatives etc.

Source: OECD, Institutional Investors Database

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

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



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

Source: OECD, Institutional Investors Database

2.2 "Alternative" institutional investors

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

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

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

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

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

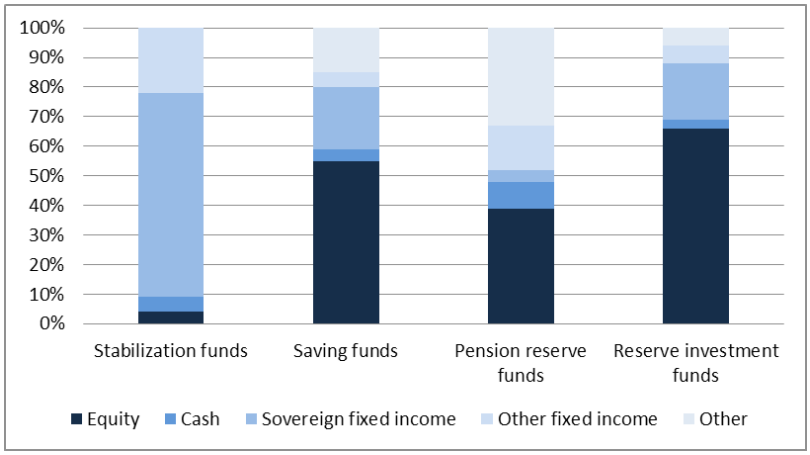
The diverse and evasive nature of SWFs is actually well illustrated by the definition of SWFs used in the *Santiago Principles* (IWG), which were agreed in 2008 and provide a framework for governance, accountability and investment practices of SWFs. The definition includes three main elements, which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

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

Again, reliable, complete and consistent information about the asset allocation of SWFs is hard to come by and more could certainly be done to improve information about the holdings of central

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

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



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

Source: IMF, Global Financial Stability Report, April 2012

The shortage of comprehensive data is an obstacle also when it comes to identifying and estimating the holdings of what are commonly referred to as private equity firms and hedge funds. Again there is no simple unifying principle in terms of investment strategy or services that defines either category. Traditionally however, pri-

vate equity firms have been seen as managing a leveraged private pool of capital through active engagement with individual companies, whereas hedge funds use an active investment strategy to benefit from arbitrage opportunities combined with leverage and derivatives (Blundell-Wignall, 2007). It is also common to differentiate between private equity firms and hedge funds with respect to the character, size and the time horizon of their equity holdings in individual companies. Private equity funds are generally seen as having large, long-term holdings in individual non-listed companies. Hedge funds on the other hand are usually associated with small non-controlling stakes in publicly listed companies (Achleitner et al., 2010).

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

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

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

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

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

2.3 Asset managers

Finally, and for the reasons explained above, we are also including asset managers under the general heading of institutional investors. In the UK Stewardship Code, asset managers (as opposed to asset owners) are defined as having the day-to-day responsibility of managing investments. The capital that they manage can be provided not only by physical persons, but also by most categories of institutional investors, including pension funds, SWFs and insurance companies. Since institutional investors also trust private equity and hedge funds with the day-to-day responsibility of managing their assets, the distinction between an asset manager and an asset owner

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

is not always clear cut. Asset managers (as we use the term in this paper), however, are not expected to invest in their own name (like a private equity firm would do) but directly in their clients' name and based on their clients' investment policy.

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

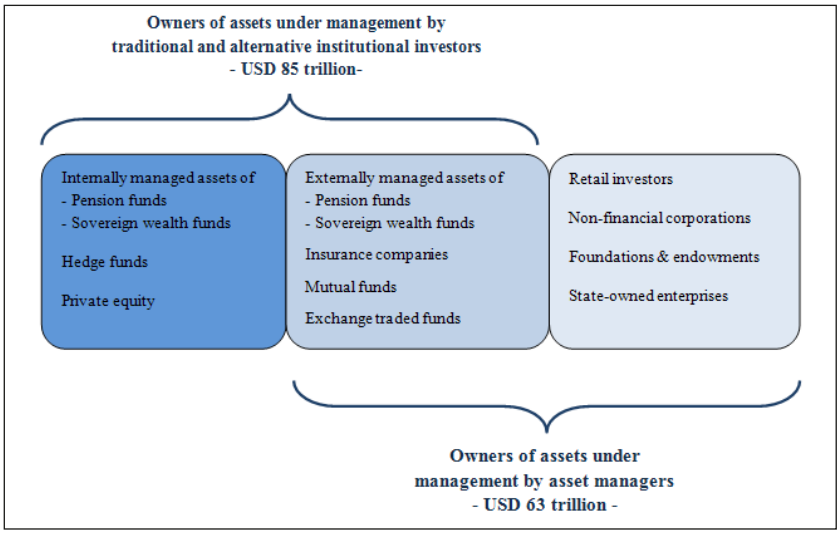
It is estimated that half of the USD 63 trillion in assets under management by asset managers is split between asset managers that are owned by insurance companies and asset managers that are owned by banks. The remainder is managed by independent asset managers (TheCityUK, 2012).

When we look at the aggregate numbers of assets under management by institutional investors it is important to note that asset managers are by far the largest sponsors of both mutual funds and exchange traded funds, which they offer to their clients as investment products. This means, for example, that the numbers for the "mutual fund" category are almost totally included in the USD 63 trillion registered as assets under management by asset managers. Also exchange traded funds, which is another product commonly sold by asset managers, such as BlackRock, are statistically included in the amount of assets managed by asset managers. Hence, just like there is a case for double counting when a pension fund invests in

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

a hedge fund, the USD 63 trillion in assets under management by asset managers should not be added to the USD 85 trillion in total assets under management by traditional and alternative investors, since there is a considerable degree of overlap. This is illustrated in Figure 7 below.

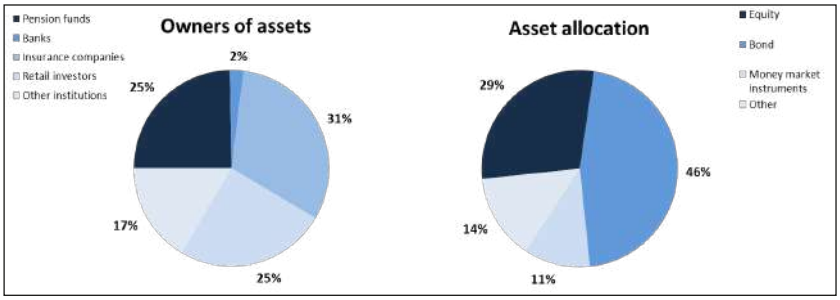
Figure 7. Owners of assets under management by institutional investors



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

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

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



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

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

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

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

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

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

2.4 The complexity of the investment chain

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

and (iii) an increase in outsourcing of ownership and asset management functions. We end this section by using one of the largest public pension funds as an illustration.

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

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

Another type of "ownership outsourcing" that has increased significantly in the last decade is the use of so called proxy advisors. The core business of proxy advisors is to sell information and recom-

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

According to ISS they cover more than 40 000 shareholder meetings in over 100 different countries. To carry out this enormous task they have 250 staff dedicated to corporate governance research. This means that each researcher on average has to cover 160 shareholder meetings per year. That is 3 ordinary shareholder meetings every week, all year round. Again, proxy advisors, like independent asset managers are themselves profit maximizing companies with the overall objective of maximizing income and minimizing costs. This has called into question the quality of the advice and the use of ready-made templates for recommendations that do not take into consideration local and company specific circumstances, but rather apply a one-size-fits all approach[11].

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

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

new instruments to which only limited number of market participants have full access.

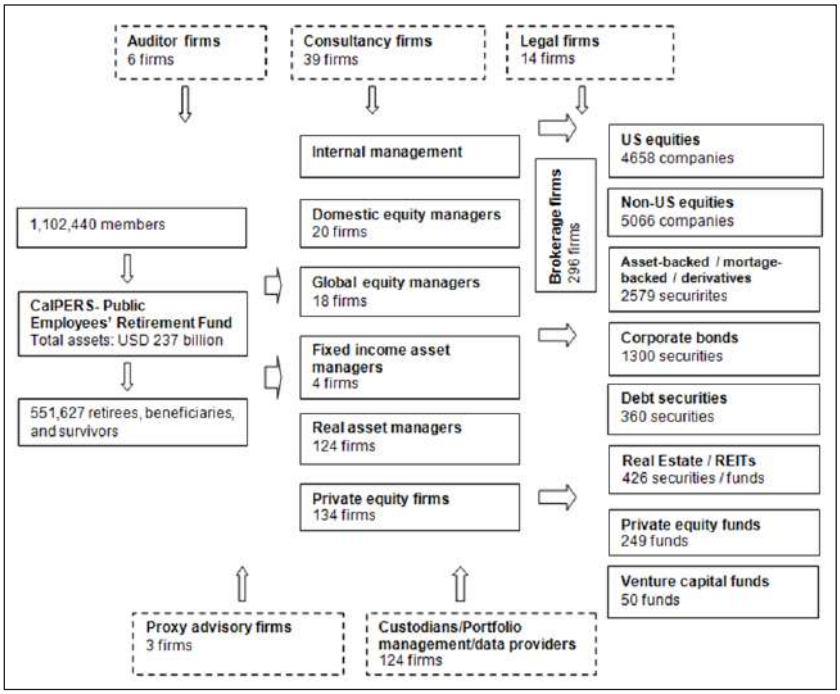
In short, we are today very far from an economy where there is a direct link between the self-interested shareholders whose income is directly dependent on the performance of the company. Instead, we have a very complex landscape of intermediary institutional investors and service providers that operate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

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

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

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

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



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

3. Ownership Engagement by Institutional Investors

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

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

the institutional investment community as a homogenous group (Millstein, 2008).

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

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

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

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

growth. In short they are providing society with new knowledge on how it can improve the allocation and use of scarce resources.

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

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

3.1 Determinants of ownership engagement

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

To illustrate this, we have identified seven different features that influence how an institution will behave as an owner. For each of

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

3.1.1 The purpose of the institution

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

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

3.1.2 The liability structure

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

3.1.3 The investment strategy

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

By "passive fundamental" we refer to investors that initially make an active choice in selecting the individual companies in which

to invest and then keep them for an extended period of time. Examples could be "strategic" national investments by a sovereign wealth fund or core investments of a closed-end investment company.

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

3.1.4 The portfolio structure

A main determinant for the degree of ownership engagement arising from portfolio structure is the degree of concentration. Or in other words, how many companies does the institution have to look after. The degree of portfolio concentration obviously covers a large spectrum, from institutions with very few holdings, to institutions like CalPERS that hold stocks in as much as 10 000 different companies. The implications for ownership engagement are simply arithmetic. The costs of exercising the same quality of informed and engaged ownership in 10 000 companies is obviously much higher than if you monitor only a handful. This is why institutions with highly diversified equity portfolios abstain from ownership engagement. Or minimize the costs of monitoring by buying services from consultancy firms that carry out the function following a pre-defined formula. As one fund manager put it "since we invest by formula we vote by formula"[13]. While a highly diversified portfolio is a pretty

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

good determinant of an institution's ownership engagement, the same is not necessarily true for concentrated portfolios. An institution with a fairly concentrated portfolio may still exhibit limited ownership engagement. Some foundations and certain sovereign wealth funds could be examples.

3.1.5 The fee structure

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

3.1.6 The presence of political and social objectives

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

cal and social objectives that translate into a certain kind of ownership engagement or positions on specific governance issues.

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

3.1.7 The regulatory framework for ownership engagement

While company law does not require any specific degree of ownership engagement from individual investors, in some jurisdictions there is a complementary regulation that does. Within the OECD, such regulations range all the way from quasi mandatory obligations for certain institutions to vote their shares, to regulations that explicitly prohibit certain institutions to vote any shares. In the United States, for example, institutions that are subject to the ERISA Act are, according to an interpretive bulletin in 2008, generally assumed to have a *de facto* obligation to vote all shares under management. In the UK the Stewardship Code is an alternative way to encourage shareholder voting. Conversely, in Sweden the Swedish pension fund AP7, which manages pension savings for 3 million people, is explicitly prohibited by law from voting their shares in any Swedish companies. The same is true for mutual funds in Turkey which are prohibited participating in the governance of the investee companies. This has been interpreted by the industry as a voting ban.

Between these extremes, countries can also have limitations on the portion of shares in an individual company that an institution may hold and vote. In some instances, the companies themselves may introduce voting caps that limit the number of votes a shareholder cast in their articles of association. Voting caps are allowed in, for example, Belgium, Denmark, France, Norway, Spain, the UK and the US. It is also fairly common that the disclosure of voting policies and practices be addressed in their rules and codes. This is

the case in, for example, Australia, Chile, Denmark, Germany, Israel, Italy, Japan, the Netherlands, Spain, Switzerland, the UK and the US where regulations and/or national codes include requirements to disclose voting policies (OECD, 2013).

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

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

Table 2. Determinants of ownership engagement

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

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

3.2 Levels of ownership engagement

In section 3.1 we discussed a set of factors and choices that influence an institution's ownership engagement. In the absence of strict regulatory requirements to engage or not engage, the degree of ownership engagement is the result of these factors and choices that together make up the institutions "business model". The fact that the business model includes the ownership of shares doesn't in itself say anything about the institution's degree of ownership

engagement. Both mutual funds and sovereign wealth funds own equity. But their engagement as owner may vary greatly as a result of other factors, such as purpose, investment strategy and portfolio diversification.

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

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

1. *No engagement:* This category comprises institutions that do not monitor individual investee companies actively, do not vote their shares and do not engage in any dialogue with the management of investee companies. Examples include those exchange-traded

funds that do not charge any fees to their investors, but instead generate income from share lending (Wong, 2010). Another example would be institutional investors that are subject to engagement limitations or an outright prohibition to vote their shares, like Turkish mutual funds.

2. *Reactive engagement:* Reactive engagement represents voting practices that are primarily based on a set of generic, pre-defined criteria that guide voting with respect to the different proposals put before the shareholders' meeting. Reactive engagement often relies on buying advice and voting services from external providers such as proxy advisors. It may also consist of reactions to engagement by other shareholders. For example, when an otherwise passive shareholder supports initiatives by another institution such as an activist hedge fund who is attempting to influence the dividend policy in a specific company or to make changes to the board. It may also include reacting to public tender offers from a private equity firm. Reactive behaviour is represented by many US pension funds and mutual funds that – subject to legal requirements[14] - vote their shares with the help of proxy advisors and also respond to shareholder campaigns led by hedge funds or private equity funds (Gilson and Gordon, 2013).
3. *Alpha engagement:* This engagement level is associated with ownership engagement that seeks to support short or long-term returns above market benchmarks. Using quite different strategies, both activist hedge funds and private equity funds can be examples of alpha engagement. Hedge funds that practise alpha engagement usually influence companies through small holdings, sometimes complemented by derivatives, actively seeking the support of other investors to support their intentions (OECD, 2007). Private equity firms on the other hand acquire large or controlling shares of companies in order to be able to restructure the company, improve its performance and, within a pre-defined period, sell with a profit.
4. *Inside engagement:* Inside engagement is an engagement level characterized by fundamental corporate analysis, direct voting of shares and often assuming board responsibilities. Owners at this engagement level typically hold controlling or large stakes in the company. A good example might include a closed-end invest-

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

ment company such as Berkshire Hathaway Inc. This company is the largest shareholder in Coca Cola Inc. and is represented on the board of Coca Cola Inc. by one of its directors. Inside engagement may also be practiced by some sovereign wealth funds.

4. Corporate Governance Taxonomy of Institutional Investors

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

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

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

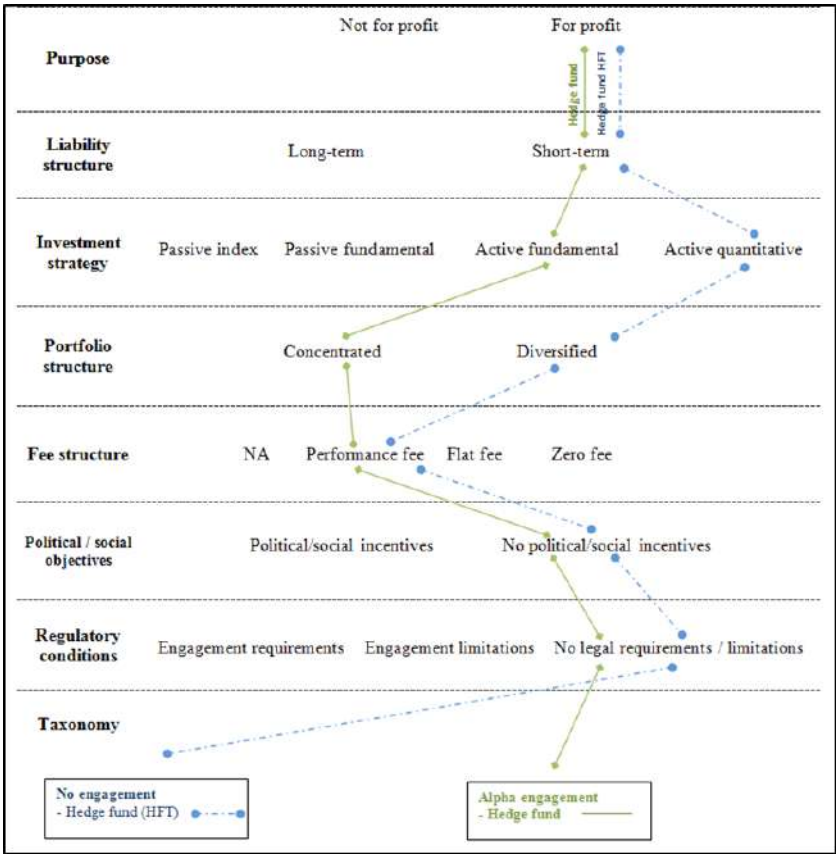
In the first two lines of the table we can see that they are both profit maximizing entities with short-term liabilities. In terms of

their investment strategy they differ in that one of them has an active fundamental strategy and the other one has an active quantitative strategy. This means that the maturity of the liability structure in itself does not preclude an active or fundamental investment strategy.

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

Where they differ is in their "investment strategy" and "portfolio structure" and, as a consequence, their respective levels of ownership engagement differ completely. The hedge fund that follows an active fundamental strategy with a concentrated portfolio will pick its investments carefully and most likely be heavily engaged in the governance of the portfolio corporations, perhaps demanding changes in strategy, dividends and board composition. The hedge fund choosing a quantitative strategy and diversified portfolio will most likely show no interest in the governance of individual companies in the portfolio and will instead rely on sophisticated software to process large quantities of information that is used for high-frequency trading through a co-located server. We have named these two levels of ownership engagement "alpha engagement" and "no engagement" respectively. Again, the main purpose of this example is not to illustrate the already well-known fact that hedge funds differ in terms of ownership engagement. But to show the usefulness of understanding and identifying the determinants that lead to these differences. And furthermore, if any of these determinants can (or should) be influenced by public policy.

Table 3. No engagement and alpha engagement



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

These investment strategies obviously result in different portfolio structures, yet in terms of fees and potential political pressures these two institutions operate under fairly similar conditions. In terms of the regulatory framework however, the public pension

fund is required to vote the shares, whereas the SWF is not subject to any such requirements. Regardless of this, the SWF will, due to the character of its investment strategy, be very hands-on in terms of ownership engagement. The public pension fund will primarily be reactive in the sense that it will either follow initiatives by other shareholders or the advice of proxy advisors that follow some pre-established criteria for voting. We have called these two levels of ownership engagement "inside engagement" and "reactive engagement" respectively.

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

Table 4. Reactive engagement and inside engagement

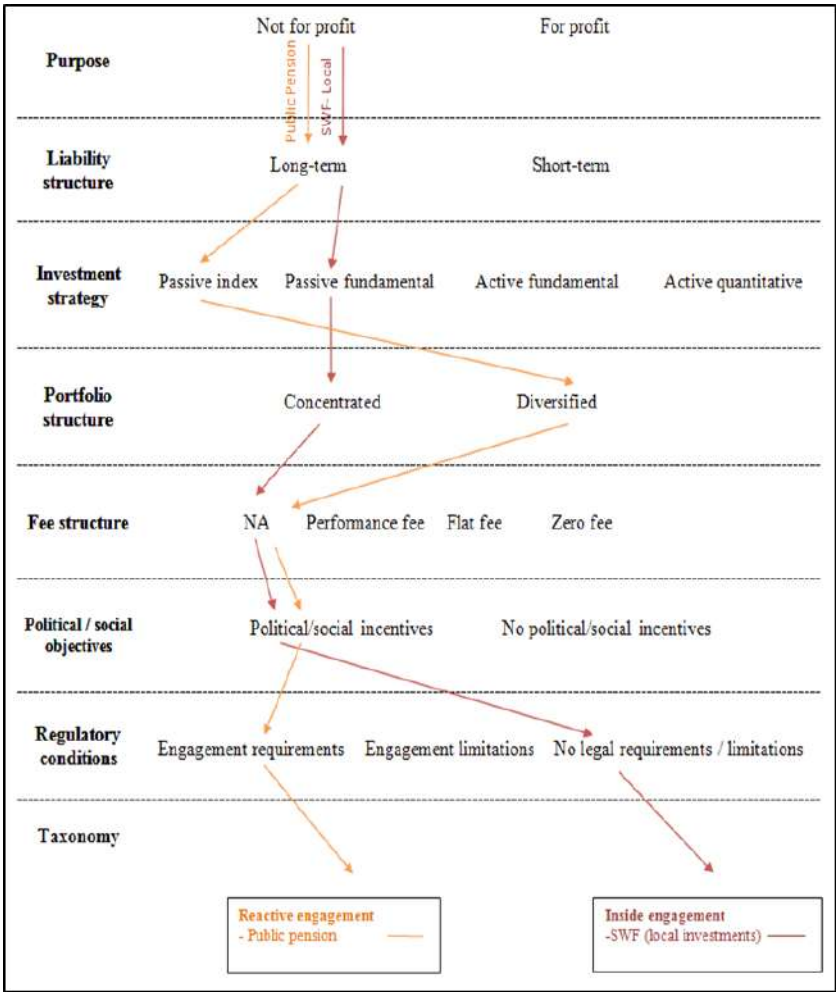


Table 5 below covers all four levels of shareholder engagement and additional examples of institutional investors.

In addition to a hedge fund that practises high frequency trading, examples of "no engagement" include an exchange traded fund that lends the shares in their portfolio and a mutual fund *that is subject to regulatory voting restrictions*. They are all for-profit institutions, with short-term liabilities, diversified portfolio structures and without any specific political or social objectives. An important difference among them is the fee structure. The hedge fund typically has a performance fee structure, the mutual fund a flat fee structure based on assets under management of the fund and the exchange traded fund

doesn't charge any fees to its investors, but generates income from share lending. While the hedge fund pursues an active quantitative investment strategy based on sophisticated software and co-location services offered by stock exchanges, both the mutual fund and the ETF pursue a passive indexed strategy. For mutual funds subject to legal limitation on engagement, this is a decisive regulatory condition for their ownership engagement.

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

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

The last level of ownership engagement, inside engagement, is illustrated by a SWF and a closed-end investment company. Both with controlling or significant stakes in listed companies. The SWF,

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

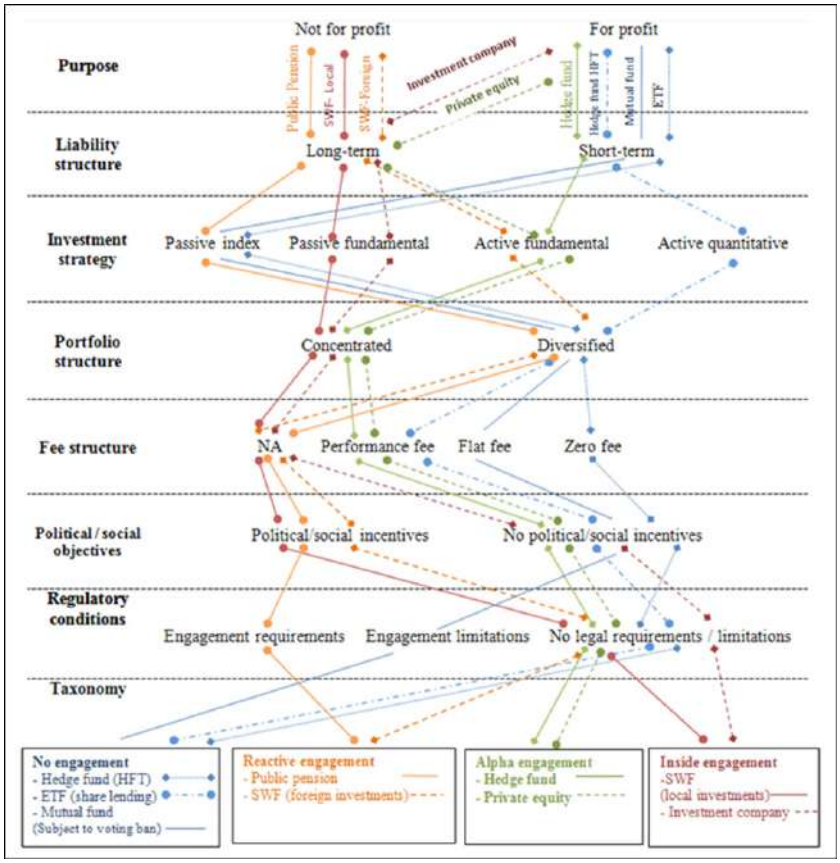
There have been other attempts to classify institutional investors.[15] The taxonomy presented above differs from most of them, since it does not aim at grouping different categories of institutional investors based on a specific and systematic criteria. Rather, the purpose is to show that in terms of ownership engagement, different institutions from two different categories may have more in common than two institutions from the same category. While the taxonomy is highly simplified, it is obvious that the informed reader, by using examples from real life, can come up with an almost endless number of combinations of features and choices that in different ways influence the character and degree of ownership engagement. And at this stage, there are at least three important messages:

[15] For instance, Goyer (2006) identifies four features that point to systemic differences between institutions: (i) the mode of collecting funds and issuing payments, (ii) the time horizon and liquidity constraints, (iii) the managerial incentives and (iv) the process of picking portfolio companies. Another classification provided by Camara (2005) is related to the dominant incentive creating forces. According to this classification, there are market driven investors which are principally motivated by financial gains (e.g. hedge funds, mutual funds), politically driven investors that are motivated by a need for the consent of others, like elections (e.g. public pension funds) and socially driven investors that are insulated from market and political forces by some combination of wealth, social position or training.

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

1. In order to understand the level of ownership engagement we need to identify a whole range of different determinants.
2. Legal or regulatory requirements for voting may have little effect on ownership engagement if other and more dominant determinants for ownership engagement remain unchanged.
3. Institutions with the highest degree of engagement typically have no regulatory obligation with respect to the degree of their ownership engagement.

Table 5. Corporate governance taxonomy of institutional investors



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