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# **Barriers to Institutional Investor Engagement**

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# Outline

- 1) Problems and policy aims**
- 2) Asset managers / institutional investors**
- 3) Proxy advisors**
- 4) Shareholder cooperation / identification**

# Problems and policy aims

## ¶ Agency conflicts

- Intermediation of investments → multiple agency relationships: investor – asset manager – proxy advisor – firm manager
- Economic benefits (specialization, overcoming collective action barriers), but also problems: information asymmetries, conflicts of interest  
→ **Managing agency conflicts**

## ¶ Short-termism

- Short holding periods (momentum trading, HFT) and quest for short-term gain
  - Beneficial effects (on liquidity and market efficiency [?]), but also problems:
    - Devaluation of long-term effects (*if* markets are myopic)
    - Impairs monitoring by (institutional) investors
    - Increased risk due to more (i) speculation and (ii) market volatility
- **Encouraging a longer-term view**

# Asset managers / institutional investors

## Regulatory concerns of the EU Commission:

### ¶ Short-termism

- Asset managers incentivized to produce high short-term gains as a quality signal  
→ trend-following strategies, risky investments

### ¶ Lack of transparency

- Opaqueness of funds with respect to issues such as strategy, costs/benefits for ultimate investors, governance issues, engagement, etc.

### ¶ Conflicts of interest

- Conflicts of interest between fund managers and ultimate investors with respect to issues such as asset valuation, management of multiple funds, etc.

# Short-termism

¶ **No plausible case for mandatory long-term engagement**

¶ **However, a ‘comply or explain’ approach might be sensible**

→ **‘EU Code of Prudent Investment Principles’**

- **For a model see 2010 UK Stewardship Code**
- **Would induce reflection on investment principles and preferences**
- **Might establish a focal point for a new equilibrium with regard to investment horizon**

¶ **Financial transaction tax**

- **Overall costs/benefits unclear: reduces momentum trading, HFT and volatility ↔ reduces liquidity and efficiency (?), increases capital costs, etc.**
  - **Design difficult: debtor and amount of tax, assessment base, transactions covered, etc.**
  - **G 20 did not agree – EU Directive proposed (2011)**
    - **Requires unanimity, but UK will not vote for it**
    - **Instrument by ‘coalition of the willing’ would shift business to UK banks**
- **Financial transaction tax for (parts of) Europe alone should not be implemented**

# Lack of transparency / conflicts of interest

¶ Existing EU Directives: UCITS (Recast 2009), AIFMD (2011)

¶ Transparency

- Increases self-control and market control, improves capital allocation
- Disclosure rules on engagement policy / activities including voting sensible

¶ Conflicts of interest

- Existing UCITS rules sufficient for public funds
- Existing AIFMD rules arguably deficient
  - In-house valuation of assets, self-made rules on management of conflicts of interest, no general duty to disclose potential conflicts of interest, etc.
  - But no plausible case for more stringent rules vis-à-vis HF/PE investors

# Proxy advisors

- ¶ **Important function as specialized monitors – activate engagement of investors for which monitoring would be inefficient**
- ¶ **Proxy advice and voting (85%), CG ratings and consulting (15%)**
- ¶ **Regulatory concerns**
  - **Lack of competition (ISS; Glass, Lewis & Co.)**
  - **Quality of service (e.g. standards for and depth of analysis [lack of firm-specificity?])**
  - **Conflicts of interest (e.g. consulting to firms and proxy advice to investors)**
  - **Lack of transparency**
- ¶ **Regulatory approach**
  - **Registration and transparency requirements, especially regarding conflicts of interest**
  - **Mandatory rules on business conduct (e.g. separation of CG consulting and proxy advice) should only be considered in case of severe market failure**

# Shareholder cooperation / identification

## ¶ Shareholder cooperation: acting in concert

- Notification requirements under Transparency Directive (2004) and mandatory obligations under Takeover Directive (2004) apply to concert parties
- Enhances capital markets efficiency and minority protection, but makes engagement / monitoring more costly → strengthens management
- Some MS such as Germany gold-plate: notification obligations from 3%, wider / vague definition of AIC, loss of rights during violation of notification obligations
- **Current AIC rules should be put into an EU Regulation with as precise an AIC definition as possible → enhances cross-border engagement, reduces uncertainty**

## ¶ Shareholder identification

- Shareholders who wish to engage can do so – passivity not caused by anonymity
- Early identification may steer resistance against engagement – entrench management
- **No steps towards a new shareholder identification regime should be taken**



# Summary

- 1) Main policy aims with respect to institutional investor engagement:  
(i) managing agency conflicts; (ii) encouraging a longer-term view**
- 2) ‘EU Code of Prudent Investment Principles’ might be a sensible tool to foster the latter aim on a comply-or-explain basis**
- 3) Asset managers should be subject to disclosure rules on engagement policy / activities including voting**
- 4) Financial transaction tax for (parts of) Europe alone should not be implemented**
- 5) Proxy advisors should be subject to registration and transparency requirements, especially regarding conflicts of interest**
- 6) Current AIC rules should be put into an EU Regulation with as precise an AIC definition as possible**
- 7) No steps towards a new shareholder identification regime should be taken**