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Luca Enriques , Giovanni Strampelli
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The Dialogue between Corporations and Institutional Investors

An Introduction

LUCA ENRIQUES AND GIOVANNI STRAMPELLI

I.1 Introduction

Institutional ownership of listed companies has grown significantly almost everywhere in the last three decades. Equity ownership has steadily moved from retail to institutional investors in that period.[1] With (minority) shares now concentrated in the hands of a relatively small number of institutions, the free-rider problem that prevented atomised individual shareholders of listed corporations from monitoring managers' (or controlling shareholders') actions and performance has become less daunting. In fact, institutional investors play an ever-increasing role in the governance of listed companies worldwide.

Not only are they capable of exerting influence on investee companies by using their voice through voting and engagement, but expectations that they do so have been growing considerably. In a context where sustainability-related issues are in the spotlight as they have never been before and legislators (especially in the EU) are nudging institutions into including ESG factors in their investment and stewardship strategies, institutions are called to engage with investee companies not only to monitor their financial performance but also to push them to pursue environmental and social goals.

However, the actual willingness of institutional investors[2] to engage with portfolio companies and to focus on ESG-related issues remains

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[1] See for an overview Amil Dasgupta, Vyacheslav Fos, and Zacharias Sautner, 'Institutional Investors and Corporate Governance' (2021) ECGI Finance Working Paper N° 700/2020. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3682800 accessed 25 June 2023.

[2] The definitions of institutional investor and asset manager are not synonymous in the text. The term institutional investor (or institution) refers to any entity that invests money on

uncertain. Indeed, regardless of whether stewardship activities are conducted at the individual company level or at the portfolio level, holding stakes that are large enough to enable them to exert pressure over investee companies and capture potential economic benefits from stewardship activities is a precondition for institutions' engagement. But several economic and legal factors can affect the propensity of institutional investors towards engagement with portfolio companies, as well as the methods by which engagement is undertaken and the topics covered.

Against this backdrop, this chapter proceeds as follows. Section I.2 provides an overview of the institutionalisation of listed companies' ownership. Section I.3 illustrates asset managers' ownership and nationality in different jurisdictions. Section I.4 describes the shift to ESG-related engagement and discusses the relevance of end-clients' preferences as a main driver of this move as well as the potential regulatory backlash arising from increasing ESG engagement. Section I.5 provides the reader with a roadmap of the book contents.

I.2 The Institutionalisation of Listed Companies' Ownership

Institutional investors dominate the ownership of publicly listed firms worldwide. At the aggregate level, they are the largest category of shareholders.[3] They hold 41 per cent of global market capitalisation, accounting for more than USD 30 trillion invested in public equity markets.[4] This is three times the amount invested by public-sector owners and six times the value of investments by strategic individuals.[5] Institutional investors' presence in listed companies, while by far stronger in the US

behalf of its clients. In addition to asset managers, the definition of institutional investors includes asset owners such as pension funds, sovereign wealth funds, banks, endowments, and insurance companies.

3 Adriana De La Cruz, Alejandra Medina, and Yun Tang, 'Owners of the World's Listed Companies' (2019), www.oecd.org/corporate/Owners-of-the-Worlds-Listed-Companies.pdf, accessed 25 June 2023; Gur Aminadav and Elias Papaioannou, 'Corporate Control around the World' (2020) 75 Journal of Finance 1191.

4 According to the OECD, the reported percentage of 41 per cent is underestimated because institutional investors are not required to disclose their full ownership in most jurisdictions due to their overall size or the limited size of their stakes. See De La Cruz et al (n 3) 13 ff.

5 According to the definitions used by ibid 4, 9. Strategic investors are 'physical persons that are either controlling owners or members of a controlling family or block-holders and family offices'.

and the UK, where ownership is traditionally highly dispersed, is relevant also in countries, such as European ones, where the percentage of companies with a controlling shareholder (be it a private entity, a family, or the state) is common.[6] For example, as reported by the OECD, institutional investors hold 26.9 per cent of total market capitalization in Italy, 27.5 per cent in France and 28.3 per cent in Germany.[7]

Focusing on the asset management industry, the market is more concentrated in the US than elsewhere: since 1980, the top 10 institutional investors have quadrupled their holdings in US stocks[8] and, at the end of 2021, the five largest mutual fund and exchange traded fund sponsors – out of a total of 825 – accounted for 54 per cent of the industry's total assets.[9] While not as dramatic as in the US, concentration within the asset management industry is significant in the EU as well. At the end of 2021, the share of assets under management (AUM) held by the top 20 EU asset managers was 43.71 per cent.[10] Relatedly, in 2021, the share of the total AUM held by the world's top 20 asset managers (all from the US, the EU, and the UK) was 45.2 per cent.[11]

The concentration process that has taken place in the asset management industry over the past few decades has mainly been fuelled by the exponential rise of passive funds and ETFs. In the US, they accounted for

[6] See online appendix of Aminadav and Papaioannou (n 3) providing percentage and identity of second and third largest categories.

[7] OECD, 'OECD Capital Market Review of Italy 2020: Creating Growth Opportunities for Italian Companies and Savers' (2020) OECD Capital Market Series, www.oecd.org/corporate/OECD-Capital-Market-Review-Italy.htm, accessed 25 June 2023.

[8] Itzhak Ben-David, Francesco Franzoni, Rabih Moussawi, and John Sedunov, 'The Granular Nature of Large Institutional Investors' (2021) 67 Management Science 6629.

[9] See Steve Johnson, 'Passive fund ownership of US stocks overtakes active for first time', Financial Times (London, 6 June 2022), www.ft.com/content/27b5e047-5080-4ebb-b02a-0bf4a3b9bc08, accessed 25 June 2023.

[10] See Detlef Glow, 'European Fund Industry Review 2021' (2022), https://lipperalpha.refinitiv.com/wp-content/uploads/2022/03/21-12-31-European-Fund-Industry-Review-2021-Awards-Edition-FINAL.pdf, accessed 25 June 2023, documenting that 2,239 promoters with at least one fund domiciled in a European fund domicile account for 56.37 per cent of the overall AUM.

[11] Thinking Ahead Institute and Willis Towers Watson, 'The world's largest 500 asset managers, 2022' (2023), www.thinkingaheadinstitute.org/research-papers/the-worlds-largest-asset-managers-2022, accessed 25 June 2023. See also Robert G. Eccles, 'Concentration in the Asset Management Industry: Implications for Corporate Engagement' *Forbes* (New Jersey, 17 April 2019), www.forbes.com/sites/bobeccles/2019/04/17/concentration-in-the-asset-management-industry-implications-for-corporate-engagement/, accessed 25 June 2023, reporting that, at that time, the top five asset managers held 22.7 per cent of externally managed assets, and the top 10 held 34 per cent.

18 per cent of US stock market capitalisation at the end of 2022, surpassing the 14 per cent held by active funds.[12] Indeed, despite its continuous growth, the passive index fund industry remains highly concentrated. The market is dominated by Blackrock, Vanguard, and State Street Global Advisors (SSGA) – the 'Big Three' – which, overall, manage over 90 per cent of all AUM in passive funds.[13]

The combination of ownership reconcentration and asset management industry concentration dynamics has a direct impact on the ownership of listed companies and carries significant corporate governance implications. Indeed, although sectoral passive funds and personalised index funds that adopt active-like investment strategies and thus comprise more concentrated portfolios are increasingly widespread,[14] giant asset managers dominating the passive funds industry are heavily invested across all companies included in major stock indexes.[15] According to Lazard, at the end of 2021, Vanguard, BlackRock, and State Street together held on average 18.7 per cent of S&P 500 companies. Their ownership of smaller companies was even more concentrated as they held 22.8 per cent of the shares in the S&P MidCap 400 index and 28.2 per cent in the S&P SmallCap 600 index.[16]

The fact that the largest asset managers are large shareholders in an enormous number of listed companies is widely documented. To our knowledge, though, available studies mainly focus on the US and data on European markets are limited.

To fill this gap, we collected data on the shareholdings of the 25 largest institutional investors in each of the continental European companies

[12] See Investment Company Institute, 'Factbook' (2023), www.icifactbook.org/pdf/2023-factbook.pdf, 23.

[13] See generally, Jan Fichtner, Eelke Heemskerk, and Javier Garcia-Bernardo, 'Hidden Power of the Big Three? Passive Index Funds, Re-concentration of Corporate Ownership, and New Financial Risk' (2017) 19 Bus and Pol 298; Lucian Bebchuk and Scott Hirst, 'Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy' (2019) 119 Colum L Rev 2029. See also Lund & Robertson, Chapter 5 in this book.

[14] See Adriana Z. Robertson, 'Passive in Name Only: Delegated Management and Index Investing' (2019) 36 Yale J Reg 795; Paul G. Mahoney and Adriana Z. Robertson, 'Advisers by Another Name' (2021) 11 Harv Bus L Rev 311.

[15] Investment Company Institute (n 14) 106 noting that "Net assets of index equity mutual funds are concentrated more heavily in large-cap blend funds that target US large-cap indexes, such as the S&P 500".

[16] Lazard, '2021 Review of Shareholder Activism' (2022), on file with the authors. See also Scott Hirst and Lucian Bebchuk, 'Big Three Power, and Why It Matters' (2022) 102 Boston UL Rev 1547.

Table I.1 *Type of largest shareholders at top 65 European companies*

Type of largest shareholder	Asset managers	Government	Foundations and mutual entities	Families, insiders, managers	Strategic individuals, other companies
No. of companies	38	8	4	9	6

included in the Euro Stoxx 50[17] and the 15 largest UK companies in the FTSE 100 as of the end of April 2022.[18] We find that leading institutional investors rank among the largest shareholders in most companies comprised in the Stoxx 50 index. On average, the top institutional shareholder at these companies owns 6.54 per cent of the equity, the top three institutional shareholders own 14.09 per cent, and the top five institutional shareholders 18.50 per cent. We also look at the cumulative shareholding of the Big Three and the Big Four (BlackRock, Vanguard, State Street, and Fidelity). As far as the top 15 FTSE 100 are concerned, the corresponding figures are 13.42 per cent and 14.65 per cent. The percentage held by the Big Three and the Big Four in the Stoxx 50 companies amounts to 8.31 and 9.40 per cent, respectively.

To shed further light on the corporate governance role asset managers can play, we also look at the basic characteristics of the shareholder base of Stoxx 50 and top 15 FTSE 100 companies. Namely, we look at the type of entity the top shareholder qualifies as and the stake it holds.

Table I.1 classifies top shareholders at these 65 companies as asset managers, government (central or local government, a state-owned enterprise, or a sovereign wealth fund), foundations and mutual entities (four cases), insiders, managers and families, and strategic individuals and other operating companies and provides the number of companies with such shareholder at the top. Interestingly, only in three companies

[17] The EURO STOXX 50 Index covers 50 blue-chip stocks from eight Eurozone countries: Belgium, Finland, France, Germany, Ireland, Italy, the Netherlands, and Spain. Therefore, it is the most representative index of European larger-listed companies.

[18] Our analysis is based on data from CapIQ that is a widely used database (owned by S&P) in the financial industry (eg equity research, asset management) for its reliability and breadth. CapIQ collects the data on the shareholdings of the top 25 institutional investors in each of the companies in the sample.

does the largest shareholder account for the majority of the share capital. The stake of the largest shareholder exceeds 30 per cent or 20 per cent in four and six companies, respectively.

With regard to the size of the Big Three's shareholdings, it is worth mentioning that there is a significant difference in the size of the stakes of the Big Three depending on whether the company has a shareholder with a stake exceeding 30 per cent of the share capital or of the voting rights. Namely, the Big Three hold together, on average, 10.22 per cent of capital in non-controlled companies and 3.45 per cent in controlled companies. As the Big Three dominate the passive investment market and their AUM are largely represented by passive funds and ETFs, the fact that the Big Three's holdings in controlled companies are lower is also explained by the fact that the benchmark indices take into account the free float. For instance, the STOXX 50 index is weighted by companies' free-float market capitalisation.[19] As a consequence, controlled companies have a lower weight in the index than widely held ones with equal total capitalisation.

I.3 Asset Managers' Ownership and Nationality

In addition to the ownership structure of investee companies and the ownership stake held in them, the nationality and ownership structure of asset managers themselves may lead to divergence in the incentives structure and in the focus of shareholder engagement.[20]

We focus on ownership as it can affect asset managers' incentives structures and, in particular, can help explain potential conflicts of interests affecting asset managers' willingness to engage. As highlighted by the European Commission, 'conflicts of interest in the financial sector seem to be one of the reasons for a lack of shareholder engagement' and

[19] See STOXX/Qontigo, 'STOXX Index Methodology guide' (2023) www.stoxx.com/document/Indices/Common/Indexguide/stoxx_index_guide.pdf, 75, clarifying that 'All the stocks on the selection list are then ranked in terms of free-float market capitalization to produce the final index selection list'. Otherwise, the FTSE 100 Index is not weighted by free-float market capitalisation. To be included in the FTSE UK index series, a security must have a minimum free float of 10 per cent if the issuing company is incorporated in the UK and a minimum free float of 25 per cent if the issuing company is incorporated outside the UK. See FTSE/Russell, 'FTSE UK Index Series, v15.8' (2023), https://research.ftserussell.com/products/downloads/FTSE_UK_Index_Series.pdf, 15.

[20] For on overview of the corporate governance implications of investors' heterogeneity see Dasgupta et al. (n 1) 57–67.

'conflicts of interest often arise where an institutional investor or asset manager, or its parent company, has a business interest in the investee company'.[21]

It is widely recognised that also independent asset managers not belonging to conglomerate financial groups can be affected by conflicts of interests that can influence their stewardship and engagement decisions. Indeed, independent asset managers having financially significant business ties with investee companies and their managers may abstain from engaging with portfolio firms and from taking an adversarial stance for fear of losing corporate business.[22] For example, in the US, asset managers may be interested in obtaining, or maintaining, the substantial revenues they derive from managing defined contribution plans ('401(k) plans') of many of their portfolio firms.[23]

Nevertheless, it can be assumed that potential conflicts of interests are more relevant for asset managers belonging to multi-services banking and/or insurance groups. Where an asset manager is owned by one such group, in addition to potential conflicts of interests arising from asset managers' business ties with investee companies, a second layer of conflicts exists. In fact, it may happen that banks and insurance companies pressure their asset management arms to avoid antagonising the clients of another of the group's arms (for example, the investment banking arm) by voting against the board or conducting adversarial engagement initiatives.[24] Of course, the intensity of intra-group conflicts of interests depends on the weight of the asset management arm within

[21] European Commission, 'Green paper: The EU corporate governance framework (Communication from the Commission' COM (2011) 164 final.

[22] See eg Simon Wong, 'How Conflicts of Interest Thwart Institutional Investor Stewardship' (*Harvard Law School Forum on Corporate Governance*, 6 Nov 2011) https://corpgov.law.harvard.edu/2011/11/06/how-conflicts-of-interest-thwart-institutional-investor-stewardship/, accessed 25 June 2023.

[23] See Bebchuk and Hirst (n 18) 2059 ff.; Dijana Cvijanović, Amil Dasgupta, and Konstantinos E. Zachariadis, 'Ties that Bind: How Business Connections Affect Mutual Fund Activism' (2016) 71 Journal of Finance 2933, finding that investment managers are more likely to vote in support of portfolio company managers on closely contested proposals when the investment manager has significant business ties to the portfolio company. See also Benjamin Braun, 'Asset Manager Capitalism as a Corporate Governance Regime' in Jacob S. Hacker et al. (eds), *The American Political Economy: Politics, Markets, and Power* (CUP, 2021), 270.

[24] See eg Simon Wong (n 24); European Commission (n 23) 14, noting that in financial groups 'the asset management branch may not want to be seen to actively exercise its shareholder rights in a company to which its parent company provides services or in which it has a shareholding'. Along the same lines see Miguel A. Ferreira, Pedro Matos,

the group. The higher the asset management arm's contribution to the group's profits, the lower the influence of other group's branches over the asset management arm should be.

Moreover, asset managers belonging to banking and/or insurance groups could be less keen on conducting engagement initiatives because they can rely on a large base of group-captive clients and are less interested in winning over new clients. Hence, reputational (or marketing-related) incentives to engage with investee companies may be lower for such asset managers.

Nevertheless, available anecdotal evidence shows that European asset managers controlled by banking or insurance companies do conduct a significant number of engagements covering a wide range of ESG issues. For example, according to evidence provided by the London-based think-tank InfluenceMap,[25] European bank- and insurance-controlled asset managers, including BNP Paribas Asset Management, Legal & General Investment Management, UBS Asset Management, Aviva Investors, and AXA Investment Management, showed greater transparency around the targets of company engagements and the topics discussed, and engaged more intensively on climate-related issues than US independent peers. Relatedly, AXA, BNP Paribas, Legal & General, Aviva, and Allianz all supported 80 per cent or more of climate-relevant resolutions, while big US players, namely BlackRock, Vanguard, and Fidelity Investments, declined support for 75 per cent of them.

To shed light on asset managers' ownership and its potential impact on investors' approach to engagement we collected ownership data on the top 20 US asset managers and the top 20 European (EU and UK) asset managers[26] and tracked their weight in Stoxx 50 companies and the

and Pedro Pires, 'Asset Management within Commercial Banking Groups: International Evidence' (2018) 73 Journal of Finance, 2181.

25 InfluenceMap, 'Asset Managers and Climate Change 2021' (2022), https://influencemap.org/report/Asset-Managers-and-Climate-Change-cf90d26dc312ebe02e97d2ff6079ed87. Similar evidence is also provided by ShareAction, 'Voting Matters' 2022 (2023), https://shareaction.org/reports/voting-matters-2022/general-findings#finding5, finding that 'there is a clear regional divide. European asset managers, on average, backed 81% of proposals in 2022 compared to 69% in 2021. By contrast, we continue to find particularly poor performance from US asset managers. US managers backed on average less than half (43%) of the environmental and social resolutions on our list in 2022'.

26 We obtained data on AUM from the worldwide ranking provided by ADV Ratings (www.advratings.com/top-asset-management-firms#google_vignette) that includes the world's top 50 asset managers. Twenty of them are from the US. Only 17 are from Europe. To have the same number of asset managers from the two continents and to facilitate

top 15 FTSE 100 companies. Based on ownership data for the companies in our sample, we excluded the four US asset managers (Pimco, Prudential Financial, Edward Jones Investments, and TIAA) and the four EU and UK asset managers (Aegon, Insight, Generali, APG) which the CapIQ database does not capture, either because they do not invest in equity (Pimco) or because none of their stakes is among the top 25 holdings by institutional shareholders in any of the companies in the dataset. Therefore, our final sample includes 16 US asset managers and 16 European asset managers.

We grouped asset managers in the following categories: bank-owned; insurance-owned; publicly owned (including asset management companies listed on a stock exchange); independent and team-owned; others (including asset managers with peculiar ownership structures which do not fall in any of the above categories).[27] The independent and team-owned category includes asset management companies that are not listed and whose stakes are owned privately either by entities other than banks, insurance companies or other entities identified separately in the list (eg pension funds or sovereign wealth funds), or by their own workers and/or management team.

We find that bank-owned asset managers make up the largest category among the EU's largest asset managers: nine out of the 16 of them are bank-owned, whereas in the US banks own six out of the 16 asset managers in the sample. By contrast, large publicly owned and independent asset managers are much more common in the US: nine out of the top 16 US asset managers included in the sample are listed or independent firms not belonging to banking or insurance groups. By contrast, there are only three listed companies among the top 16 European asset managers.[28]

comparisons, we have added the three European asset managers not already in the list that appear most frequently among the shareholders of the companies in our dataset (EuroStoxx 50 and top 15 FTSE companies), namely two German managers (Deka and Union AM) and a UK one (Baillie Gifford).

27 Namely, only two asset managers fall into this category: APG Asset Management, which is a wholly owned subsidiary of Stichting Pensioenfonds ABP ('ABP'), one of the largest pension funds in the world, and Norges Bank Investment Management that is the sovereign wealth fund of Norway.

28 Amundi is also a publicly traded company, but we classify it as bank-owned because Credit Agricole Group owns roughly 70 per cent of the share capital. It is also worth mentioning that Schroders, one of three listed companies among the top 17 European asset managers, is controlled by the Schroders family which owns 43.16 per cent of capital.

As far as US publicly owned or independent asset management companies are concerned, it is perhaps unsurprising but no less noteworthy that, with the exception of Vanguard,[29] they all have other top asset managers among their shareholders.[30] For example, Vanguard is the largest shareholder of BlackRock and SSGA, and Fidelity ranks among Vanguard's largest shareholders. Similarly, Vanguard, BlackRock, and SSGA are the three largest shareholders of T. Rowe Price and Northern Trust Global Investments Limited and rank among the largest shareholders of Invesco. Moreover, leading asset managers are large shareholders in some banks and insurance companies that have an asset management arm ranked among the top 20 investors.[31]

Whether cross-shareholdings among leading asset managers can affect their approach to engagement, especially regarding social and environmental matters, is controverted. On the one hand, as a recent op-ed in the Wall Street Journal contends, cross-shareholdings make leading asset managers non-independent actors.[32] According to this view, common ownership explains why major asset managers do share common ESG preferences and regularly engage on these topics. An alternative point of view is that common ownership in the asset management industry is too low to influence the preferences and behaviour of leading investors. It is in fact the case that the most influential shareholders of some asset managers do not hold significant stakes in their rivals. For example, the most influential shareholder at Fidelity Investments, FMR LLC (which is controlled by Fidelity's founder family), does not hold any stakes in other asset managers. Moreover, the fact that the Big Three and other major asset managers push on the ESG rhetoric and spend increasing sums in ESG-related engagements may support the view that they compete for investment flows by attracting clients who are more sensitive to ESG issues.[33]

29 Vanguard's ownership structure is fairly unique as it is owned by its funds. Thus, Vanguard is owned by the people who invest in its funds and has no outside shareholders other than its clients.
30 See Dan Morenoff, 'Break Up the ESG Investing Giants', *Wall Street Journal* (New York, 31 August 2022), www.wsj.com/articles/break-up-the-esg-investing-giants-state-street-blackrock-vanguard-voting-ownership-big-three-competitor-antitrust-11661961693, accessed 25 June 2023.
31 See Gerald Epstein, 'The asset management industry in the United States', (2019) Financing for Development series 271, 12 ff., https://repositorio.cepal.org/bitstream/handle/11362/45045/1/S1900994_en.pdf, accessed 25 June 2023.
32 Morenoff (n 32).
33 We thank Martin Schmalz for his insights on this issue.