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

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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

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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

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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

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Shareholder cooperation / identification

Shareholder cooperation: acting in concert

- 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

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