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# Institutional investors and stewardship

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# Institutional investors and stewardship

*by*

Kenta Fukami, Daniel Blume, Carl Magnus Magnusson*

The sustained growth of institutional investors’ assets under management, together with the growing use of passive investment strategies, raises the question of whether existing frameworks adequately address issues related to investor engagement and disclosure. There has been a growth in the regulation of institutional investors and market intermediaries to address conflicts of interest and to enhance their transparency. In parallel, the adoption of stewardship codes and the number of signatories to such codes has been increasing. Their proliferation and to some extent convergence offers insights on recognised good practices. The paper also explores the apparent increase in engagement among institutional investors with respect to environmental, social and governance (ESG) issues, their increasing reliance on ESG ratings and data services, and whether regulatory frameworks or guidance should evolve to take into account these new developments.

Authorised for release by Carmine Di Noia, Director, OECD Directorate for Financial and Enterprise Affairs.

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# Introduction

This paper looks at the main trends and issues related to the increasing ownership of institutional investors in listed companies and the implications for shareholder stewardship and engagement. It supports the OECD Corporate Governance Committee's ongoing review of the G20/OECD Principles of Corporate Governance (G20/OECD Principles), the international standard in the field of corporate governance. This paper focuses more specifically on institutional investors and their different types of governance engagement, notably the recent increase in the use of stewardship codes and environmental, social and governance (ESG) ratings as a governance tool. It also addresses other issues such as hard law approaches and the regulation of proxy advisory services.

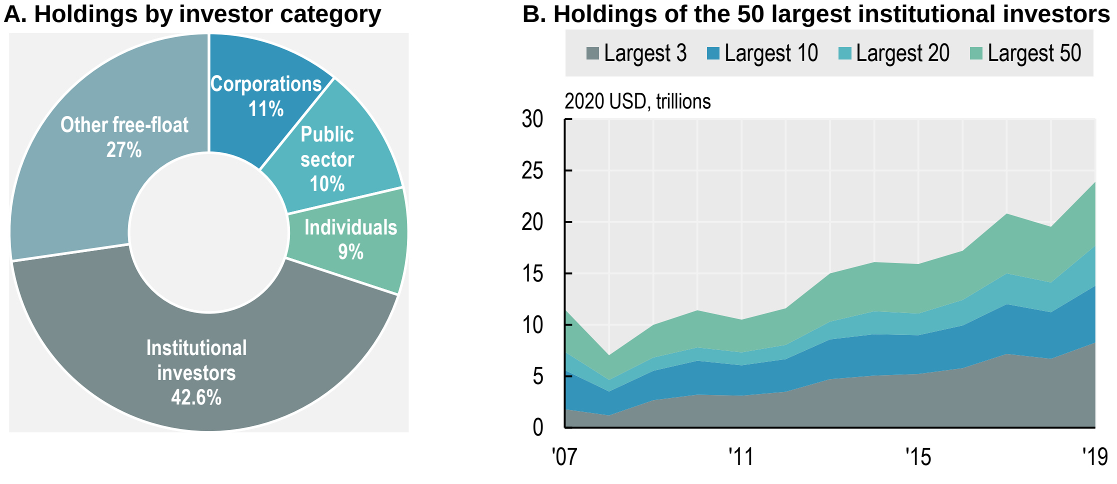
With the sustained growth of institutional investors' assets under management, some jurisdictions, notably the United States and many European countries, have seen a continuing concentration of ownership by institutional investors, especially in large listed companies. This trend, together with the growing use of passive investment strategies, raises the question of whether existing frameworks and incentives are sufficient to encourage a critical mass of more active shareholders to play their expected ownership roles. While there has been a growth in the regulation of both institutional investors and market intermediaries to address conflicts of interest and to enhance their transparency, there remains considerable variation across jurisdictions. In parallel, there has been an increase in the adoption of stewardship codes and the number of signatories to such codes. Their proliferation and to some extent the convergence around certain good practices may offer insights on recognised good practices for consideration in the review of the G20/OECD Principles. A final important recent trend to be considered is the increase in engagement among some institutional investors with respect to ESG issues and their increasing reliance on ESG ratings and data services, raising questions as to whether legal and regulatory frameworks or guidance should evolve to take account of these new developments.

# 1 Institutional ownership in public equity markets

In recent decades, most advanced markets have seen an increase in the importance of various forms of institutional ownership, replacing direct ownership by individual households. This shift is most pronounced in the United Kingdom, where direct ownership by households fell to 13.5% in 2018, with different categories of institutional investors, notably insurance companies and pension funds, being the dominant category of owners. Japan has also seen a marked decrease in equity directly held by households, from around 30% in 1980 to 18% in 2021. The same is true in the United States, where households, which were relatively significant owners of public equity until the 1980s, have progressively been replaced by institutional investors as the dominant owners of publicly listed.

As a result, institutional investors now represent a substantial part of equity ownership globally. At the end of 2020, they owned 43% of global market capitalisation of listed companies, equivalent to almost USD 44 trillion (De La Cruz, Medina and Tang, 2021[1]). This makes them the single largest investor category, with public equity holdings four times larger than those of both corporations and the public sector (Figure 1.1, Panel A). From 2007 to 2019, the equity holdings in listed companies by the 50 largest institutional investors grew from USD 12 trillion to USD 24 trillion in real terms (Figure 1.2, Panel B). The three largest institutional investors owned 9.3% of global market capitalisation and the ten largest 15.5% in 2019.

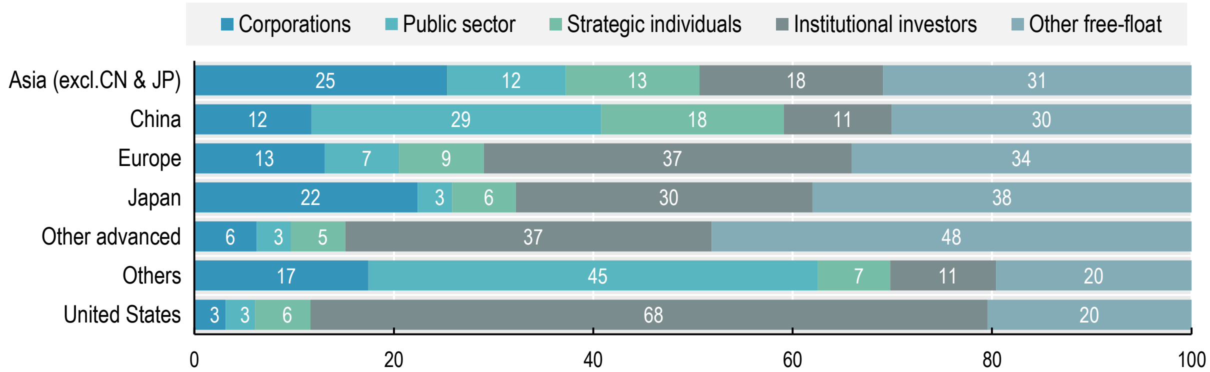
### Figure 1.1. Institutional investors' holdings of publicly listed equity globally




Note: The category "other free-float" mainly includes direct retail investments and holdings by institutional investors that are below the disclosure thresholds. The figures are based on ownership records for 25 766 listed companies from 92 markets.
Source: OECD Capital Market Series dataset, FactSet, Bloomberg, OECD-ORBIS Corporate Finance dataset, Thomson Reuters Datastream.

The aggregate figures mask significant regional disparities. While institutional investors hold substantial portions of publicly listed equity in many regions, they are particularly prominent in the United States, where they hold 68% of the market capitalisation. They are also important investors in Europe (37%) and Japan (30%).

## Figure 1.2. Holdings of listed equity by investor category and region, end-2020

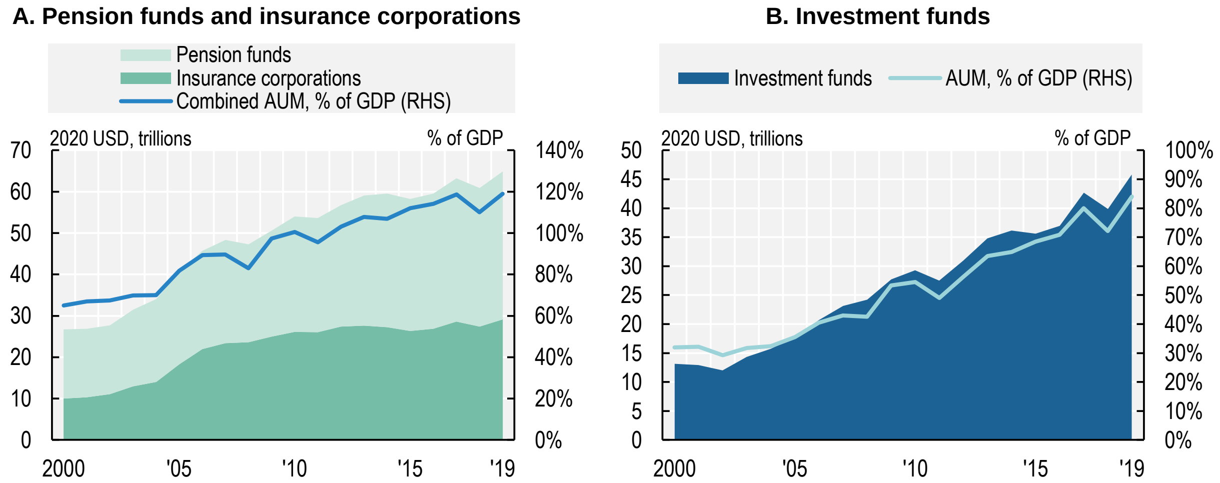



Note: Based on ownership records for 25 766 listed companies from 92 markets.
Source: OECD Capital Market Series dataset, FactSet, Thomson Reuters, Bloomberg.

One important driver behind the increased importance of institutional investors as corporate owners has been the remarkable growth in their total assets under management since 2000. In real terms, the aggregate assets under management by insurance corporations and pension funds in OECD countries have grown from around USD 27 trillion in 2000 to USD 65 trillion in 2019. This represents an increase from 65% to 119% of GDP (Figure 1.3, Panel A). This has to a large extent been driven by the transition from pay-as-you-go pension systems to funded pension plans and the privatisation of pension funds.

Similarly, investment funds (in which both pension funds and insurance corporations invest) have grown from USD 13 trillion to USD 46 trillion during the same period, representing an increase from 32% to 84% of GDP (Figure 1.3, Panel B). The degree of cross-investment between traditional institutional investors has also been increasing. Specifically, investment fund units as a share of total equity investment by pension funds has grown from 32% in 2000 to 49% in 2019. The corresponding figures for insurance corporations are 49% and 62%.

## Figure 1.3. Assets under management (AUM) by institutional investors in OECD countries

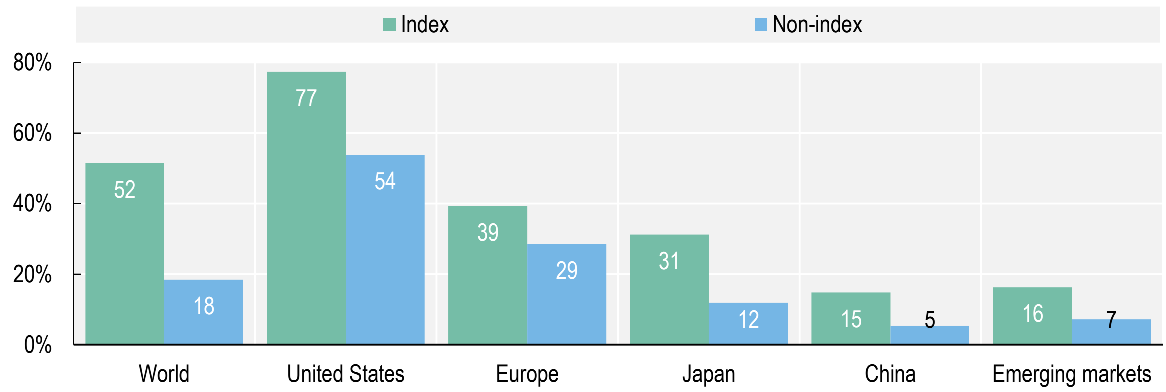



Source: OECD Institutional Investors Database.

Another development that has contributed to the strong growth in institutional ownership in public equity markets is the surge in the use of large, highly diversified investment vehicles (such as broad index funds) as an investment strategy. Such investment vehicles have enabled retail investors to gain exposure to the broader market and to diversify away from firm-level risk at low fees. This has resulted in a substantial increase in indirect ownership, in turn giving rise to increasingly long and complex investment chains. The link between the beneficial owner of a security and the record holder often passes through multiple intermediaries (for example, an individual's pension may be held in a pension fund, which invests in an investment fund, which in turn may invest in other funds which finally hold the actual shares in companies).

The popularity of index investment strategies has had a profound effect on the allocation of institutional investors' assets and the ownership structure of listed companies. Index investment strategies concentrate the allocation of funds in a limited group of companies included in a major index. Illustrative of this, Figure 1.4 below shows the difference in institutional investor ownership in companies that are included in the MSCI World Index compared to those that are not. At the global level, the difference is quite striking – at the end of 2020, the average institutional investor ownership of companies included in the index was 33 percentage points higher than of those not included in the index. The difference, although not equal in magnitude, is significant in all regions. These dynamics are likely to continue intensifying as index funds continue to grow. For example, index mutual funds and index ETFs' share of the total fund market in the United States more than doubled between 2010 and 2020, from 19% to 40% (Investment Company Institute, 2021[2]).

### Figure 1.4. Average institutional ownership of companies (not) in the MSCI World Index, end-2020




Source: OECD Capital Market Series dataset, FactSet, Thomson Reuters, Bloomberg, MSCI Constituents Information (as of December 2020).

# 2 Key issues

The effectiveness with which capital is allocated among different business opportunities depends to a large extent on the functioning of the primary and secondary equity markets. But it also depends on the commercial business models, incentives and ownership strategies of the investors. Because investors differ with respect to these characteristics, it is also likely that systemic changes in the relative importance of different kinds of investors over time will influence the way in which capital is allocated among listed companies and how the performance of these companies is monitored.

The fact that institutional investors' holdings have risen dramatically in the last decades has shifted attention to their responsibility to act as stewards of the companies in which they hold shares. As the annotations to Principle III.A of the G20/OECD Principles point out, the effectiveness and credibility of the entire corporate governance framework and company oversight depend to a large extent on institutional investors' willingness and ability to make informed use of their shareholder rights and effectively exercise their ownership functions in companies in which they invest. While business models of individual institutional investors vary, given their fiduciary duty to their clients and ultimate beneficiaries, it is reasonable to expect that at least some institutional investors will focus on maximising long-term value and that they will engage with companies to achieve this objective. Proper shareholder engagement by responsible owners should ultimately benefit society as a whole. It is therefore important to address how institutional investors' incentives to engage in investee companies may be misaligned with the interests of their beneficial investors and also key ways in which regulators and companies alike are seeking to deal with this issue, notably with respect to regulation, stewardship codes, proxy advisors and ESG ratings.

## 2.1. Institutional investors in the G20/OECD Principles

The rights and equitable treatment of shareholders and key ownership functions are addressed in Chapter 2 of the G20/OECD Principles, and institutional investors, stock markets and other intermediaries are addressed in Chapter 3. While Chapter 2 focuses more heavily on ensuring the protection of shareholder rights and their equitable treatment, Chapter 3 is more concerned with ensuring that the framework provides "sound incentives throughout the investment chain" to support the functioning of stock markets "in a way that contributes to good corporate governance".

In addition to stressing the important role of institutional investors in contributing to the effectiveness and credibility of the entire corporate governance framework, the introductory annotations to Chapter 3 also outline the complexity of corporate governance and ownership when, as is often the case, the investment chain is long and complex, with numerous intermediaries standing between the ultimate beneficiary and the company, influencing the incentives and the ability to engage in traditional corporate governance. At the same time, the annotations note the significant increase in the share of equity investments held by institutional investors, including mutual funds, pension funds, insurance companies and hedge funds, each with varying abilities and interests related to corporate governance engagement. While some may incorporate shareholder engagement into their business models, others may follow business models and investment strategies that do not include or motivate spending resources on active engagement. The annotations suggest that for those investors with more passive engagement strategies, "mandatory requirements to engage, for example, through voting, may be ineffective and lead to a box-ticking approach". Nevertheless, the chapter includes a number of recommendations to help frame the engagement of institutional investors and other market intermediaries, and also takes note of the relatively recent trend of some countries "to consider adoption of codes on shareholder engagement ("stewardship codes") that institutional investors are invited to sign up to on a voluntary basis".

Chapter 3 includes a number of recommendations related to institutional investors, including "to disclose their corporate governance and voting policies with respect to their investments" (Principle III.A); and "to disclose how they manage material conflicts of interest that may affect the exercise of key ownership rights regarding their investments" (Principle III.C). In addition, the chapter includes a recommendation on market intermediaries, recommending that "The corporate governance framework should require that proxy advisors, brokers, rating agencies and others that provide analysis or advice should disclose and minimise conflicts of interest that might compromise the integrity of their advice or analysis" (Principle III.D). In terms of facilitating shareholder engagement, Chapter 2 also contains an important recommendation that "Shareholders, including institutional shareholders, should be allowed to consult with each other on issues concerning their basic shareholder rights as defined in the Principles, subject to exceptions to prevent abuse" (Principle II.D).

## 2.2. Governance implications of increased institutional investor ownership

The rise of institutional ownership in public equity markets has resulted in lengthened and increasingly complex investment chains, concentration of ownership, and a growing popularity of index investment strategies, which all have important implications for corporate governance. For example, the basis of a diversified fund's business model is to remove firm-specific risk by investing in a large number of companies and thereby augment risk-adjusted returns. However, the gain from a value increase in a single portfolio company will have, at best, a minor impact on the overall portfolio performance, and so it is likely to be outweighed by the costs of collecting relevant information, identifying the potential issue, soliciting support from other shareholders, and exercising governance rights to attempt to address it. More fundamentally, because any benefits stemming from such engagement are widely dispersed and shared with other shareholders whereas the cost is carried by the engaging fund alone (which is unattractive in a competitive environment), the incentives for firm-specific engagement are minimal. This is the case particularly under a flat fee structure, which is typically used by large, diversified funds. Under such a structure, possible benefits from engagement with individual firms are unrelated to the fees collected, so asset managers are instead incentivised to increase their assets under management by competing on costs.

The misalignment of institutional investors' incentives to engage in investee companies with the economic interests of their beneficial owners is a long-standing but increasingly important concern in some jurisdictions, in particular where the concentration of ownership by institutional investors is a dominant pattern of ownership for listed companies. While shareholder engagement may not be part of some institutional investors' business models and investment strategies, lack of engagement by those institutions may lead to "absentee landlord" shareholders. This problem is especially acute for listed companies in which the institutional investors collectively have a significant influence.

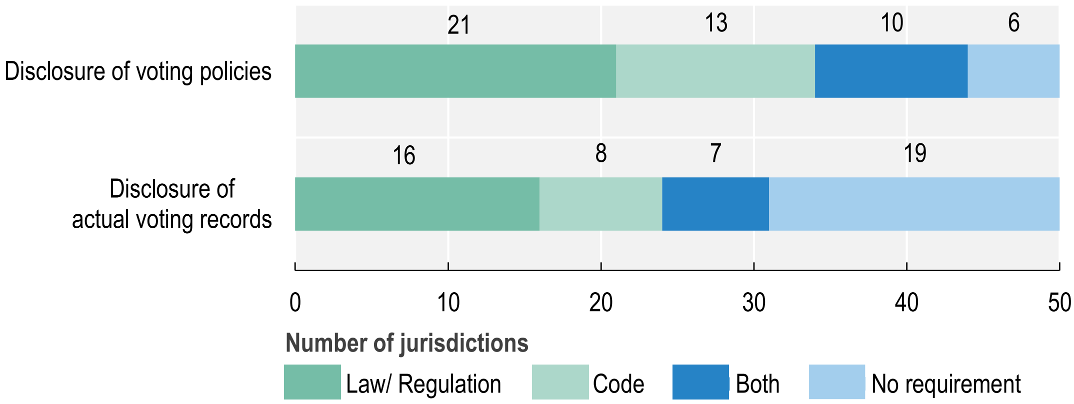
The implication of this concentration of ownership (and voting rights) in a small number of very large traditional institutional investors who have very limited incentives to engage in traditional firm-by-firm corporate governance is an undervaluation of governance rights. Shares in companies are valued primarily as cash flow rights as the importance of the governance right attached to corporate ownership diminishes. However, ownership engagement plays an important part in capital allocation and corporate monitoring and thus has a wider social and economic value. Addressing under-engagement is therefore a critical concern for policy makers around the world, who use a mix of mandatory requirements and voluntary codes.

### *2.2.1. Mandatory requirements related to institutional investor engagement*

According to the 2021 OECD Corporate Governance Factbook (OECD, 2021[3]), some jurisdictions have introduced regulatory requirements with respect to institutional investors' exercise of voting rights. For instance, in Chile, the law states that pension funds' opinions and interests must be stated at shareholder meetings and that their influence on management is indirect through the election of a share of independent directors in the investee companies. In Israel, institutional investors (including fund managers, pension funds, provident funds and insurance companies) must participate and vote on certain resolutions. In India, institutional investors are required to monitor and engage with investee companies in matters including the company's strategy and performance, quality of leadership, corporate governance, ESG considerations, and shareholder rights. They are also required to formulate a clear policy for collaboration with other institutional investors (OECD, 2022a[4]). Switzerland implemented the Ordinance against Excessive Compensation in 2014, requiring pension fund schemes to vote in the interest of their insured persons on specific matters, such as election of the members of the board of directors and compensation committee; and compensation to the board of directors and executive management.

Another relevant area concerns the disclosure of voting policies and voting records. Following the implementation of the EU's Shareholder Rights Directive II (SRD II), there has been a major increase in the number of jurisdictions requiring institutional investors to disclose voting policies and voting records. The EU Directive sets out comply-or-explain disclosure requirements for institutional investors and asset managers to develop a policy on shareholder engagement, make the policy available on their web site, to disclose how they have implemented the policy, and to report annually on how they have voted at general meetings (EU, 2017[5]). In 21 jurisdictions out of 50 covered in the Factbook, companies are required by law or regulation to disclose voting policies and in 16 jurisdictions to disclose actual voting records.

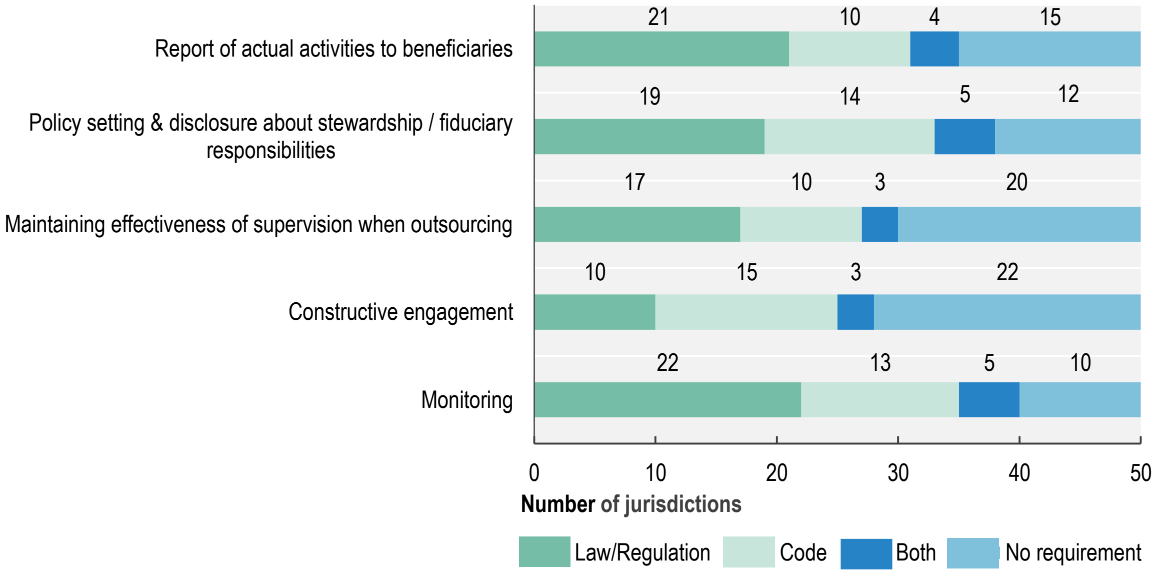
**Figure 2.1. Disclosure of voting policies and actual voting records by institutional investors**




Source: OECD (2021[3]), OECD Corporate Governance Factbook 2021, https://www.oecd.org/corporate/corporate-governance-factbook.htm.

A growing number of jurisdictions also establish specific requirements with regard to various forms of ownership engagement, such as monitoring and constructive engagement with investee companies and maintaining the effectiveness of monitoring when outsourcing the exercise of voting rights. Requirements that institutional investors monitor investee companies (22 jurisdictions) and report actual activities to beneficiaries (21) are most common. Constructive engagement, generally involving direct dialogue with the board or management, is now required in ten jurisdictions. In 17 jurisdictions, it is required that institutional investors maintain the effectiveness of monitoring when outsourcing the exercise of voting rights to proxy advisors or other service providers.

### Figure 2.2. Stewardship and fiduciary responsibilities of institutional investors




Source: OECD (2021[3]), OECD Corporate Governance Factbook 2021, https://www.oecd.org/corporate/corporate-governance-factbook.htm.

### *2.2.2. Stewardship codes: A soft law approach to institutional investor engagement*

As emphasised in the G20/OECD Principles, the mandatory elements of the corporate governance framework can usefully be complemented by voluntary recommendations in order to allow for flexibility. Indeed, in recent years many countries have introduced codes on shareholder engagement – stewardship codes – that institutional investors are invited to sign up to on a voluntary basis. In addition to the rise in institutional ownership of public equity, this trend has also been driven by the significant increase in cross-border investments by institutional investors. When foreign-based investors hold an important portion of the market and requirements only apply to the domestic institutional investors, they may not be very effective in enhancing ownership engagement by institutional investors. In this context, many jurisdictions have given increasing attention to voluntary initiatives that both foreign and domestic institutional investors can commit to follow.

A stewardship code is a set of principles stipulating standards for how institutional investors should engage with investee companies. As of the end of 2021, at least 22 jurisdictions have adopted stewardship codes in some form. Table 2.1 presents a non-exhaustive list of the structure of codes in eight selected jurisdictions.

The G20/OECD Principles state that institutional investors should develop and disclose their policies on how they exercise ownership functions in their investee companies (Principle III.A) and on how they manage material conflicts of interest (Principle III.C). In the majority of jurisdictions shown in Table 1, however, stewardship codes cover a broader set of issues, such as how institutional investors monitor investee companies, when and how they should escalate stewardship activities, and when and how they should act collectively with other investors.

### Table 2.1. Stewardship codes in selected jurisdictions

| | Australia | Brazil | Canada | Italy | India | Japan | Korea | United Kingdom | United States |
|---|---|---|---|---|---|---|---|---|---|
| Develop and disclose policy on how they discharge stewardship/ownership responsibilities | ● | ● | ● | ● | ● | ● | ● | ● | ● |
| Develop and disclose policy on managing conflicts of interest | ● | ● | ● | ● | ● | ● | ● | ● | ● |
| Monitor investee companies | ● | ● | ● | ● | ● | ● | ● | ● | ● |
| Establish guidelines on when and how they should escalate stewardship activities | ● | ● | ● | ● | ● | ○ | ● | ● | ● |
| Act collectively with other investors where appropriate | ● | ● | ● | ● | ● | ● | ○ | ● | ● |
| Develop policy on voting and disclosure | ● | ● | ● | ● | ● | ● | ● | ● | ● |
| Report periodically on stewardship and voting activities | ● | ● | ● | ● | ● | ● | ● | ● | ● |

Source: ACSI (2018[6]) Australian Asset Owner Stewardship Code, https://acsi.org.au/wp-content/uploads/2021/10/ASSET-OWNER-CODE-stewardship.pdf; AMEC (2021[7])Brazilian Stewardship Code and Principles, https://amecbrasil.org.br/stewardship/amec-stewardship-code/?lang=en; CCGC (2020[8]), Stewardship Principles, https://ccgg.ca/wp-content/uploads/2020May_2020-Stewardship-Principles-CCGG-new-branding.pdf; ASSOGESTIONI (2016[9]), Italian Stewardship Principles, https://www.assogestioni.it/sites/default/files/docs/principi_ita_stewardship072019.pdf; Securities and Exchange Board of India (2019[10]), Stewardship Code for all Mutual Funds and all categories of AIFs, https://www.sebi.gov.in/legal/circulars/dec-2019/stewardship-code-for-all-mutual-funds-and-all-categories-of-aifs-in-relation-to-their-investment-in-listed-equities_45451.html; Korea Stewardship Code Council (2016[11]), Principles on the Stewardship, http://www.cgs.or.kr/eng/business/stewardship_tab02.jsp; Financial Reporting Council (2020[12]), The UK Stewardship Code 2020, https://www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship-Code_Final2.pdf; Investor Stewardship Group (2017[13]), Investor Stewardship Group and the Framework for U.S. Stewardship and Governance, https://isgframework.org/stewardship-principles/; Japan Financial Services Agency (2021[14]), Guidelines for Investor and Company Engagement, https://www.fsa.go.jp/en/news/2021/20210611/01.pdf.

Most stewardship codes leave it at institutional investors' discretion whether to apply the codes or not. In some cases, such as in the United Kingdom or Brazil, whether to become a signatory to the code is also voluntary. In some other jurisdictions, the code is accompanied by disclosure requirements applying to all or certain categories of institutional investors, typically following a "comply-or-explain" approach, making them flexible in terms of what practices are applied. These voluntary and more flexible approaches have been conceived with a view to allowing investors to adapt the codes to their respective investment strategies, recognising the diversity of such strategies among institutional investors. However, it means that even if some institutional investors declare that they fully or partly adopt a stewardship code, in at least some cases there is no enforcement mechanism to ensure that they actually do so. In effect, stewardship codes rely to a large extent on institutional investors' willingness to engage. Elements that affect the effectiveness also include the institutional development, business practices, and the regulatory environment. In this respect, in the United Kingdom, institutional investors who want to become a signatory to the Stewardship Code must submit a report to the Financial Reporting Council (FRC) demonstrating how they have applied the Code's Principles. Once assessed and listed as a signatory, institutional investors must report annually to remain signatories. Furthermore, the FRC publishes "Effective Stewardship Reporting" which identifies good examples of reporting and clarifies expectations for good reporting on governance, resourcing, the integration of stewardship with investment and on stewardship activities (Financial Reporting Council, 2021[15]). While the assessment and regular public communication by the custodian of the stewardship code may not directly address the incentive problem arising from its voluntary nature, it can still serve as a tool to promote stewardship activities and guide institutional investors in a positive direction.

Another important development with respect to stewardship codes is the wider adoption of codes in Asian jurisdictions, where institutional investors are typically minority shareholders in listed companies. Since 2014, eight Asian jurisdictions – Japan (2014), Malaysia (2014), Hong Kong (China) (2016), India (2019), Korea (2016), Singapore (2016), Chinese Taipei (2016), and Thailand (2017) – have adopted stewardship codes. Stewardship activities often involve painstaking research, meetings with the management, and voting at the general shareholder meeting. However, in those jurisdictions, individual institutional investors typically represent a small fraction of ownership and may face challenges when they propose some actions to the management and attempt to bring about a change to the company. It is therefore crucial to consider how regulatory frameworks and practices may influence the effectiveness and success of their engagement.

### *2.2.3. Other initiatives related to stewardship*

In addition to regulatory initiatives, institutional investors themselves are also developing stewardship principles on which they base their engagement with portfolio companies. For example, along with reports on stewardship activity, Vanguard publishes its Global Investment Stewardship Principles, based on four key pillars: board composition and effectiveness; oversight of strategy and risk; executive compensation; and shareholder rights (Vanguard, 2021[16]). Similarly, BlackRock publishes the BlackRock Investment Stewardship Global Principles, covering seven key themes: boards and directors; auditors and audit-related issues; capital structures, mergers, assets sales, and other special transactions; compensation and benefits; environmental and social issues; general corporate governance matters and shareholder protections; and shareholder proposals (BlackRock, 2021[17]).

It is important to note that while the resources invested in stewardship engagement by large institutional investors are increasing rapidly, they remain very small relative to the size of their investment portfolios. For example, in 2020 BlackRock voted on 160 700 proposals in 17 000 shareholder meetings across 55 markets. In comparison, its stewardship team consisted of around 45 people (BlackRock, 2020[18]). Similarly, Vanguard’s stewardship team of 35 people voted on 137 826 proposals in 10 796 companies across 29 markets in the first half of 2021 alone (Vanguard, 2021[19]). It is worth noting that these are some of the largest stewardship teams in the industry (Mooney, 2020[20]). To be sure, engagement teams of this size allow for a significant number of strategic and visible interventions with companies that may have a wider impact in sending a signal about institutional investor expectations to other companies in the market. Nevertheless, the large number of investee companies held in many institutional investors’ portfolios raises the question of how widely stewardship teams can meaningfully engage with their investee companies, and the extent of their dependence on proxy advisors.

A recent initiative to address this misaligned incentive is for institutional investors to give their clients the right to vote their indirectly held shares. For example, from 2022 BlackRock will allow certain clients to participate directly in proxy voting decisions. These clients may choose to cast the votes themselves, but can also rely on proxy advisory recommendations, identifying only certain proposals they are interested in voting on themselves, or may simply continue to rely on BlackRock’s stewardship team. At a first stage, this measure will apply to institutional clients invested in BlackRock’s index strategies (amounting to roughly USD 2 trillion in equities), but it may be expanded to other investors and products at a later stage (Posner, 2021[21]). The impact of this measure is yet to be assessed, but may serve to increase shareholder engagement and heterogeneity in voting (and thus information production). However, the effectiveness of the initiative is contingent on the clients themselves actually investing enough time to participate in proxy voting processes.

## 2.3. Proxy voting and advisory services

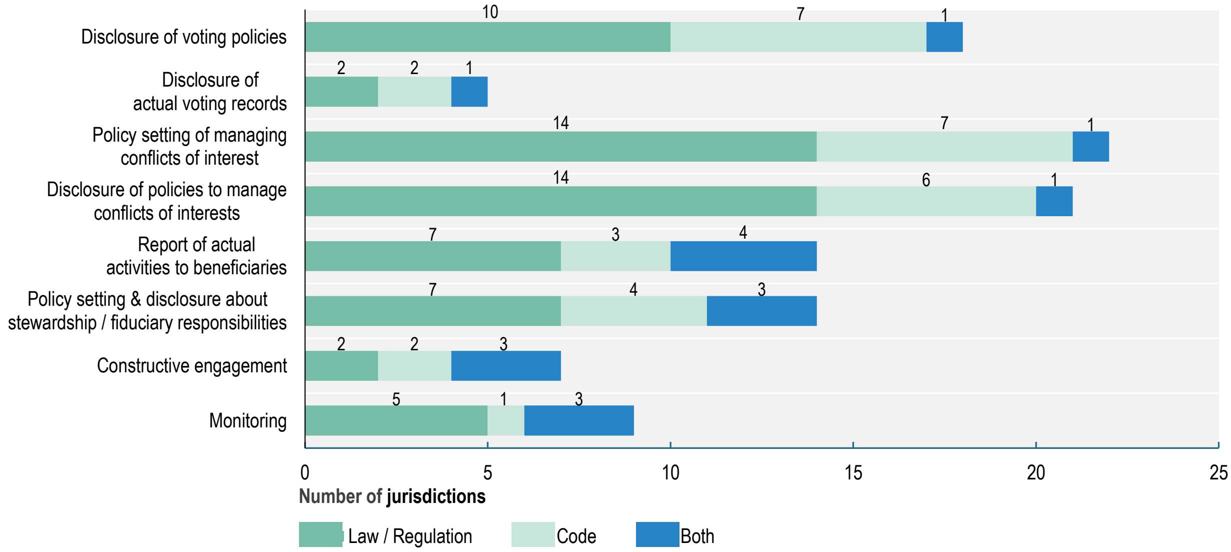
Because of the substantial difficulty for institutional investors with portfolios comprising thousands of companies to do research ahead of shareholder votes for each shareholder meeting at which they vote by proxy, institutional investors commonly use the services of proxy advisors. The proxy advisory industry is heavily concentrated, with two firms – Institutional Shareholder Services (ISS) and Glass Lewis – representing an estimated combined market share of 97% (Larcker, Tayan and Copland, 2018[22]). ISS reports covering 45 000 meetings in over 115 markets, executing 12.2 million ballots for 1 500 institutional clients (ISS, 2021[23]). Similarly, Glass Lewis covers more than 30 000 meetings across 100 markets for 1 300 clients (Glass Lewis, 2021[24]). This gives proxy advisory firms significant influence over the shareholder voting processes, and although the evidence is not clear cut, research has indicated strong correlations between proxy recommendations and actual voting outcomes (Larcker, Tayan and Copland, 2018[22]). It has been argued that the growth of proxy advisors has undermined the information generation process that precedes a shareholder vote, and that their dominance has homogenised voting behaviours (Spatt, 2019[25]).

The G20/OECD Principles (Principle III.D) recommend that proxy advisors (and other service providers that provide analysis and advice relevant to investor decisions) should "disclose and minimise conflicts of interest that might compromise the integrity of their analysis or advice." For example, such conflicts may arise when proxy advisors provide advice on a matter in which their affiliates have a material interest, because they also offer other services, such as consulting and ESG ratings, or they have other material relationships.

In recent years, there have been some important regulatory developments regarding proxy and other advisory services. The 2021 edition of the OECD Corporate Governance Factbook shows that regulatory requirements related to proxy advisors have become increasingly common, although there are significant differences in the regulatory approaches taken. A number of jurisdictions have established stand-alone laws or regulations specifically applicable to proxy advisors, in some cases supplemented by additional guidance. For example, in the United States, the SEC has rules in place relating to "solicitations" by proxy advisory firms and other entities engaged in solicitation. Separately, the SEC issued guidance regarding the proxy voting responsibilities of investment advisers exercising proxy voting authority with respect to client securities, including examples to help investment advisers comply with their obligations regarding proxy voting. In India, proxy advisers generally do not vote on behalf of their clients but are nevertheless required to formulate and disclose their voting recommendation policies to their clients (OECD, 2021[3]).

The EU's SRD II recognises the importance of proxy advisor services for institutional investors, and notes that they "may also have an important influence on the voting behaviour of investors". It therefore requires proxy advisors to "disclose certain key information relating to the preparation of their research, advice and voting recommendations and any actual or potential conflicts of interests or business relationships that may influence the preparation of the research, advice and voting recommendations". Proxy advisors should also disclose what (if any) code of conduct they comply with and explain any deviations from it. In the case that they do not follow a code of conduct, they should explain why they do not (EU, 2017[5]).

## Figure 2.3. Requirements and recommendations for proxy advisors




Source: OECD (2021[3]), OECD Corporate Governance Factbook 2021, https://www.oecd.org/corporate/corporate-governance-factbook.htm.

The use of proxy advisory services is also recognised in stewardship codes. The UK stewardship code, for example, contains principles for service providers (explicitly including proxy advisors) in addition to institutional investors. The code also asks signatories to "state the extent to which they use default recommendations of proxy advisors" (Financial Reporting Council, 2020[12]). The Malaysia's Code also recommends that institutional investors encourage their service providers (which include proxy advisors) to apply the principles of the Code where relevant and to conduct their investment activities in line with the institutional investors' own approach to stewardship. Accordingly, service providers are also encouraged to be signatories of the Code. Japan takes a similar approach, recommending in its stewardship code that service providers "contribute to the institutional investors' effective execution of stewardship activities" (The Council of Experts on the Stewardship Code, 2020[26]).

## 2.4. ESG considerations and ESG ratings

The significant implications of environmental changes for the economy – notably with respect to climate change – have brought increased attention to how institutional investors engage with investee companies on environmental, social and governance (ESG) issues. For this reason, some jurisdictions have recently included ESG considerations into their stewardship codes. For instance, Japan's stewardship code was revised in 2020 to include sustainability considerations that are consistent with investment strategies. The revised UK stewardship code also states that "[s]ignatories will be expected to take environmental, social and governance factors, including climate change, into account and to ensure their investment decisions are aligned with the needs of their clients" (Financial Reporting Council, 2019[27]).

Other jurisdictions, also following the implementation of the EU's SRD II, have implemented legislation to enhance institutional investor engagement on ESG issues and increase related disclosure. The EU's SRD II significantly expanded duties and reporting requirements for institutional investors and asset managers by requiring them to publish an engagement policy describing how they monitor investee companies' non-financial performance, social and environmental impact and corporate governance as well as to disclose on annual basis how such engagement policy has been implemented (EU, 2017[25]). In France, Article 173-VI of the Energy Transition Law was updated in 2015 to require institutional investors to disclose information about how they incorporate environmental, social and quality of governance objectives into their investment and risk management policies.[1] In 2020, Singapore issued guidelines setting out the Monetary Authority of Singapore's (MAS) expectations on environmental risk management for fund management companies.

Investors have increasingly come to pay attention to and incorporate questions related to ESG into their investment and voting decisions. Although preceding the COVID-19 crisis, this trend has been given further impetus by the pandemic, which not only highlighted the importance of identifying systemic risks, but also arguably increased general expectations on corporations regarding issues across the ESG spectrum by making them more salient (OECD, 2020[28]).

In response to increasing regulatory attention and investor demand, ESG rating and data providers have grown rapidly to help institutional investors integrate ESG considerations into their investment processes. ESG ratings, rankings, and scoring typically assess corporations based on their disclosure which help determine ESG scores. (OECD, 2020[28]). Metrics and methodologies used to assess ESG performance are however very diverse. Rating providers' methodologies may vary with respect to how they collect data, what information sources they rely on (public disclosure, questionnaires, or data produced by third party suppliers), how they process collected data (raw, aggregate, clean, correct or estimate), how they weigh quantitative or qualitative factors, and how they set out subcategory metrics (OECD, 2020[28]).

Nevertheless, in relation to their Environmental pillar, the methodologies have the potential to contribute to the low-carbon transition by rewarding issuers' alignment with climate-related objectives and progress towards sustainability goals, in addition to rewarding the adoption and disclosure of climate related policies and targets (OECD, 2022[29]). A possible approach aimed at developing greater consistency and comparability of such ratings would be the adoption of internationally recognised metrics which facilitate the alignment of disclosures with the climate transition – such as the Task Force on Climate-related Financial Disclosure (TCFD) and the OECD Due Diligence Guidance for Responsible Business Conduct to support better risk management (OECD, 2021[30]; OECD, 2021[31]).

One estimate finds that there are 160 ESG data and rating providers worldwide. However, the market is dominated by a small number of large players (IOSCO, 2021[32]). At the end of 2019, data provider Refinitiv produced ESG scores for companies representing 78% of global market capitalisation, and 95% of US market capitalisation (OECD, 2020[28]). Other notable providers of ratings and data include for example Bloomberg, Dow Jones, ISS, MSCI and Thomson Reuters (Huber and Comstock, 2017[33]). It should be noted that there is commonly an overlap between intermediaries as ESG rating providers are also often index providers (as well as proxy advisors in some cases).

The effect of the increased interest in the issue and availability of data is that ESG data and ratings have emerged as indirect engagement tools for institutional investors. Crucially, by making ESG criteria part of their portfolio allocation process, institutional investors are making companies' actions, strategies and policies related to ESG a cost of capital question. While not a panacea for under-engagement by institutional investors, this is interesting because it encourages companies to take such considerations seriously for financial reasons, without the investor needing to engage with individual companies. Importantly, their direct effect on capital allocation also distinguishes ESG ratings from other corporate governance intermediation services, most notably proxy advisory services which, while certainly important for some voting outcomes, are not as evidently determinants of capital flows. In light of their growing relevance, further improvements in disclosure requirements and their consistency may allow institutional investors to improve their communication of ESG-related decisions and performance criteria to beneficiaries and shareholders (OECD, 2020[28]). The fact that companies themselves use ESG ratings as a variable in deciding executive remuneration supports this theory. According to one survey, ESG metrics are used in annual executive incentive plans by 63% of constituent companies of major European indices, and in 52% of the companies in the S&P 500 (Willis Towers Watson, 2021[34]). Among FTSE

[1] *Loi sur la Transition Énergétique pour la Croissance Verte – LTECV.*

100 companies, 45% have an ESG measure in executive pay (PwC, 2021[35]). While not all these metrics are based on data from an ESG rating provider (a company may have internal measures of ESG impact), these figures are illustrative of the importance of such data in the corporate ecosystem generally, and as corporate governance tools more specifically.

Because of their effects on the cost of capital and corporate behaviour, ESG ratings and data possibly provide a way for investors whose business models and/or regulatory environments do not provide the incentives or possibility for direct engagement to incorporate ESG matters into their corporate governance process. This is part of the type of engagement that stewardship codes seek to promote.

The growing role of ESG rating providers has implications for corporate governance. First, when ESG ratings are used as a tool to guide institutional investors' investment decisions and engagement, the lack of comparability and in some cases lack of transparency of methodologies may provide a biased picture of the company. Importantly, ESG considerations that are part of investors' engagement and voting strategies may not be consistent with the methodology used by the ESG rating provider. Second, conflicts of interest may arise if the ESG rating provider has a material interest in the covered entity such as by providing a consulting service or trading securities/derivatives of the company. Lastly, research shows that large market capitalisation companies tend to receive higher scores than smaller ones, which in turn may reinforce an existing tendency for institutional investors to favour investments in the largest publicly listed companies. The higher scores obtained by larger companies may be due in part to the ability of large cap firms to dedicate more resources to ESG reporting which ESG rating providers heavily rely on (OECD, 2020[28]).

Because institutional investors also use ESG ratings to guide their engagement strategies and the quality of ESG ratings affects engagement with investee companies, transparency around process, methodologies and data sources is key to providing unbiased and reliable data. It bears mentioning that since investors may use raw ESG data (and weigh ratings based on internal models) rather than the ratings provided by the data/rating providers, the well-documented equivocality of ESG ratings and the fact that there are often large discrepancies between ratings of the same company from different providers may not necessarily be a concern for the use of these data as an engagement tool if accompanied by sufficient transparency. Nevertheless, the differences in underlying assumptions and scores across ratings providers may also risk undermining public confidence in markets and their use of such tools.

These developments suggest that ESG ratings and data have become a legitimate intermediary function in the corporate governance process and should be analysed as such, keeping in mind Principle III.D of the G20/OECD Principles, which underlines that such intermediaries can play an important role in shaping good corporate governance practices. Indeed, regulators have recently begun paying closer attention to ESG rating providers that play an increasingly important role in capital markets but do not fall under the existing regulatory perimeter. In July 2021, IOSCO published its consultation report on ESG ratings providers that includes proposed policy recommendations. Some jurisdictions including Japan have initiated a discussion on how to integrate these recommendations into their regulatory frameworks, but the increasing reliance of institutional investors on ESG ratings providers requires further discussion from a corporate governance perspective.

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