Submission to the European Commission's consultation
'The EU corporate governance framework'
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About FairPensions

FairPensions is the operating name of Fairshare Educational Foundation, a UK registered charity that exists to promote responsible investment ("RI") among pension funds and other institutional investors. This generally involves shareholder engagement on environmental, social and governance (ESG) risks with the potential to affect long-term financial returns. We also work to improve transparency and accountability to ultimate beneficiaries, both through our own industry benchmarking surveys and through engagement with policymakers at UK and EU level.

FairPensions is supported by a number of leading UK charities and trade unions, including Oxfam, Amnesty International, Greenpeace, ActionAid, CAFOD, Unison, Unite and WWF. We are also supported by over 8,000 individuals. Further information about FairPensions can be found on our website: http://www.fairpensions.org.uk.

Introduction

In March of this year, we published the results of a year-long research project on institutional investors' legal obligations to their beneficiaries: *'Protecting our Best Interests: Rediscovering Fiduciary Obligation'*. The report deals with many of the issues raised in this consultation as possible barriers to greater shareholder engagement, including short-termism, agency problems, conflicts of interest and lack of transparency.

Although the report's legal analysis focuses on UK law, it draws on international comparisons throughout, including other member states. Many of the legal principles we discuss are enshrined in EU law, for instance through the *IORP* directive and, to a lesser extend, *MiFID*. Moreover, in the course of our research we found that, notwithstanding the significant differences between jurisdictions (most significantly between civil and common law jurisdictions), the same issues surrounding interpretations of fiduciary obligations appear to arise across these jurisdictional boundaries. We therefore hope that the report will be a useful contribution to the Commission's deliberations. A copy of the report is enclosed, and we make reference to it (as "our report") throughout this submission.

Boards of directors

Q9: Should disclosure of remuneration policy, the annual remuneration report (a report on how the remuneration policy was implemented in the past year) and individual remuneration of executive and non-executive directors be mandatory?

Yes. Transparency on remuneration is vital to enable shareholders to ensure that remuneration is aligned with the long-term interests of the company and of the ultimate beneficiaries of investments. There is a strong case for mandatory public disclosure, not only because of the significant public interest in this information, but also because it is by far the easiest way to ensure transparency and accountability to the millions of individuals whose savings are ultimately invested in listed companies through institutional investors such as pension funds and insurers.

In addition, the knowledge that remuneration packages are subject to public scrutiny may in itself help to act as a check on excessive executive remuneration which serves neither companies, investors nor the wider economy. In the UK, the 'closed system' of interlocking remuneration committees and remuneration consultants has helped to drive up the 'market rate' for directors' pay, while individual companies protest that they cannot pay less without losing talent. Full disclosure seems unlikely to accelerate this 'race to the top', as some have suggested; on the contrary, it could contribute to pay restraint.

Q10: Should it be mandatory to put the remuneration policy and the remuneration report to a vote by shareholders?

In a UK context, we have long argued that the shareholders' advisory vote on remuneration[1] should be made binding. We have also suggested that, where shareholders reject the remuneration report in respect of directors or senior management, the chairman of the remuneration committee should be required to resign. Specifying a binding rather than advisory vote would be a useful extension of Recommendation 2004/913/EC.

Q11: Do you agree that the board should approve and take responsibility for the company's 'risk appetite' and report it meaningfully to shareholders? Should these disclosure arrangements also include relevant key societal risks?

Yes. Our comments focus primarily on the question of whether disclosure should include key societal risks. As indicated in our response to the Commission's consultation on non-financial reporting, we believe that there is often a lacuna in company reporting of key environmental, social and governance (ESG) risks associated with the company's core business. On the one hand, financial and narrative reports often neglect ESG issues or do not integrate them in a meaningful way. On the other hand, corporate social responsibility reports often focus on activities which are peripheral to the company's core business, such as volunteering or charitable donations. There is a need to bridge the gap between these two types of reporting.

The same principle can be applied to reporting of a company's risk appetite. If 'societal risks' are to be reported, this must be done in a meaningful way which allows shareholders to exercise genuine oversight. In other words, reporting must cover the company's approach to its key risks in a fair and balanced way, rather than simply being treated as another opportunity to demonstrate good corporate citizenship. Information disclosed must be robust and reliable, with key assumptions underlying risk judgements disclosed. And disclosures should be comparable, to enable shareholders to make comparisons across sectors or across their portfolios.

Q12: Do you agree that the board should ensure that the company's risk management arrangements are effective and commensurate with the company's risk profile?

Yes.

Shareholders

Q13: Please point to any existing EU legal rules which, in your view, may contribute to inappropriate short-termism among investors and suggest how these rules could be changed to prevent such behaviour.

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1 Section 439, Companies Act 2006

We sympathise with concerns that pension fund accounting rules may contribute to investor short-termism. Anecdotally, we hear that triennial valuations based on mark-to-market accounting can dominate the thinking of UK pension trustees, making them feel obliged to focus on maximising the value of the fund in the short-term, particularly in the immediate run-up to a valuation, rather than focusing on long-term sustainable value creation. We would welcome any attempt by the Commission to revisit these rules and explore alternative accounting mechanisms that reflect the long-term position of the fund without creating perverse incentives.

Our report analyses the ways in which interpretations of fiduciary obligation may contribute to investor short-termism. As already mentioned (see Introduction), although our analysis focuses on the UK legal framework, this is also relevant at a European level. Many of the common-law fiduciary principles on which the UK framework is based have been translated into European law - for instance through Article 18 of the *"IORP"* Directive, which states:

> *1. Member States shall require institutions located in their territories to invest in accordance with the "prudent person" rule and in particular in accordance with the following rules:*
>
> *(a) the assets shall be invested in the best interests of members and beneficiaries. In the case of a potential conflict of interest, the institution, or the entity which manages its portfolio, shall ensure that the investment is made in the sole interest of members and beneficiaries;*
>
> *(b) the assets shall be invested in such a manner as to ensure the security, quality, liquidity and profitability of the portfolio as a whole.*

As we point out in chapters 1 and 3 of our report, these principles have often been interpreted as requiring investors to maximise the short-term profitability of the fund whilst ignoring wider factors which might affect the long-term interests of beneficiaries – including environmental sustainability and financial system stability. This appears to be the case not just in the UK but in many – though not all – member states. Many UK trustees fear that taking a long view which gives full consideration to such issues will leave them exposed to liability if it causes the fund to perform less well in the short term. There is evidence that this perception also dominates in many other Member states.[2] In addition, the 'prudent person' rule is generally interpreted by reference to the behaviour of other investors, which may exacerbate herding behaviour in the markets. UK trustees often report feeling unable to diverge from the prevailing investment strategies of their peers for fear of being sued for breach of their fiduciary obligations.

These 'fiduciary-like' legal provisions could be reviewed, or additional guidance issued, to make clear that investors should take a broad approach to the long-term best interests of their beneficiaries, and that they are not legally restricted to a narrow focus on short-term return. In the UK, our report suggests that such a provision could be modelled on section 172 of the Companies Act 2006, which specifies that in discharging their duties to the company, directors should 'have regard' to the long-term consequences of their decisions and to a range of wider factors including environmental and community impacts.

Q14: Are there measures to be taken, and if so, which ones, as regards the

2 See for example UNEP-FI, 2005, *'A legal framework for the integration of environmental, social and governance issues (ESG) into investment decision-making'.*

incentive structures for and performance evaluation of asset managers managing long-term institutional investors' portfolios?

We agree that resolving agency problems created by the relationship between asset owners and asset managers is crucial to tackling short-termism in the capital markets. In our response to the June 2010 Green Paper we supported greater disclosure of asset managers' incentive structures. We also welcome practical initiatives to help pension funds move towards incentive structures that are better aligned with their beneficiaries' interests.

Research evidence suggests that pension funds recognise the problem of short-termism but are still struggling to adopt solutions. For instance, in a 2008 survey of leading European pension funds, there was very high agreement that most investors act in too short-term a manner, and that short-term, benchmark-relative remuneration structures were partly to blame for this. Respondents estimated their ideal investment horizons at 23 years, and their actual investment horizons at just 6 years.[3]

We believe there are two key factors behind this difficulty in moving from recognition of the problem to adoption of solutions:

Firstly, there may be a collective action problem whereby most asset owners recognise the problem, but nobody is willing to 'jump first' to solve it (the herding problem). Interpretations of fiduciary duty may exacerbate this, since investors worry that they could be legally exposed for 'imprudent' behaviour if they depart from industry norms. In this case, regulators could contribute to the solution by creating an independent initiative for change – for instance, by developing codes of best practice – or by clarifying that the 'prudent man' standard does not require investors to slavishly follow the herd.

Secondly, there could be practical barriers to implementation of solutions. Two key practical barriers we have come across are:

- A lack of practical alternatives for structuring mandates and measuring asset manager performance, resulting in continuing reliance on short-term, benchmark-relative performance. Work such as the International Corporate Governance Network's model mandate initiative aims to tackle this problem, and regulators could help by funding or otherwise facilitating such practical work.
- Pension funds feel constrained by accounting rules, particularly triennial valuations based on mark-to-market accounting, which may create perverse incentives to boost short-term returns to the fund at the expense of a long-term approach. We would support efforts to update these rules or to explore how their original objectives could be achieved without the creation of perverse incentives for short-termism.

In summary, there are various measures that could be taken to encourage long-term incentive structures and performance evaluation for asset managers. We would suggest that the best approach is to tackle the underlying causes – whether this be interpretations of fiduciary duty, lack of practical solutions, perverse regulatory incentives, or a simple collective action problem – rather than introducing new regulatory requirements on investors' contracts with their asset managers.

Q15: Should EU law promote more effective monitoring of asset managers by institutional investors with regard to strategies, costs, trading and the extent to which asset managers engage with the investee companies? If so, how?

3 Axel Hesse, 2008, *'Long-term and sustainable pension investments: a study of leading European pension funds'*

Effective monitoring of asset managers by institutional investors is essential to ensuring that beneficiaries achieve good outcomes, that conflicts of interest are adequately managed, and that companies are well run and responsibly owned. Our report argues that the complexity of modern investment chains make monitoring an essential fiduciary function. For example, under the UK trust-based system, the trustees who hold fiduciary duties increasingly do not make day-to-day investment decisions. It is therefore a key part of their fiduciary role to exercise effective oversight of the asset managers who do this on their behalf. The rise in popularity of 'fiduciary management' in several member states – whereby even more key fiduciary functions are outsourced – illustrates the need for greater clarity about the nature of this oversight role and of the division of responsibilities between institutional investors and their asset managers.

We welcomed the UK Stewardship Code, which, although primarily directed at asset managers, explicitly recognises the need for asset owners to monitor their managers' stewardship performance. In our response to the June 2010 Green Paper, we supported the idea of a pan-European Stewardship Code. We feel this would be preferable to a proliferation of national Codes, which adds complexity and creates a risk of arbitrage.

Another way in which the legal framework can promote more effective monitoring is through mandating improved transparency. We have long advocated mandatory public disclosure of voting records for institutional investors at UK level, and agreed in our response to the June 2010 Green Paper that this should be made mandatory at EU level to ensure a level playing field and a coherent disclosure regime for investors operating in international markets.

Public disclosure of voting records would ensure that asset managers disclose full information, not only to their institutional clients, but also to end-beneficiaries - the individuals whose money is at stake. FairPensions works to empower beneficiaries to monitor asset owners and to hold their agents to account regarding their engagement on particular issues. In our experience UK beneficiaries often find it difficult or impossible to access information about voting intentions and/or decisions. We welcome the improvements driven by the introduction of the UK Stewardship Code, but continue to believe that voluntary initiatives will be insufficient to produce an adequate level and quality of disclosure. This was illustrated by the UK Investment Management Association's recent survey on uptake of the Code, which found that 36% of respondents still did not disclose their voting records.[4] In addition, research by FairPensions has found that far fewer investors disclose meaningful information about their engagement with companies outside of voting at AGMs.[5]

Improved transparency would also be helpful in other areas. For instance, as the UK Pensions Regulator recently noted, it can be difficult for asset owners to access full information about the level of fees. Neither Annual Management Charges (AMCs) nor total expense ratios (TERs) cover all relevant costs: *"Researchers do attempt to gain a full picture of the total costs, but it can be difficult to establish and present in a comparable form."*[6] In particular, the level of portfolio turnover is vital to a full understanding of real charges, since the transaction costs associated with 'churn' can be significant.[7] In the UK there is no requirement to disclose levels of turnover or associated costs, and we have

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4 IMA, 2011, *'Adherence to the FRC's Stewardship Code: as at 30 September 2010'*

5 FairPensions, 2010, *'Stewardship in the Spotlight'*

6 TPR, 2011, *'Enabling good member outcomes in work-based DC provision'*, p36

7 See for example Paul Woolley, 'Why are financial markets so inefficient and exploitative – and a suggested remedy', in LSE, 2010, *'The Future of Finance'*

anecdotal evidence (cited in our report) that pension trustees are not always able to access this information even when they request it.[8] New disclosure requirements would therefore be one option for the Commission to consider. Another option would be to collate and publish comparative data on charges – an approach which, as the UK Pensions Regulator notes, has been pursued in other jurisdictions including Australia.[9]

Q16: Should EU rules require a certain independence of the asset managers' governing body, for example from its parent company, or are other (legislative) measures needed to enhance disclosure and management of conflicts of interest?

We agree with the Commission that commercial relationships between investee companies and asset managers' parent companies may compromise effective stewardship. More generally, we believe that robust management of conflicts of interest is crucial to ensuring good outcomes for savers.

In the UK, there is some confusion over the nature of the legal requirements facing asset managers in relation to conflicts of interest. Although asset managers are subject to MiFID requirements and related national regulatory rules, there is uncertainty over whether they are also subject to more stringent *fiduciary* duties to avoid (rather than simply manage or disclose) conflicts of interest. The UK Law Commission concluded in 1995 that asset managers are indeed subject to fiduciary duties,[10] yet many within the industry have rejected that conclusion in responding to our report. We believe there is a compelling case that asset managers should be subject to stringent requirements to avoid and manage conflicts of interest, given the discretion they exercise, the asymmetry of information between managers and their clients and the vulnerability of clients in this regard. We would include institutional as well as retail clients in this assessment: the assumption that institutional investors are 'sophisticated' or 'professional' clients able to look after their own interests is not always warranted, as the UK Myners Report noted a decade ago.[11] On the question of transparency, our research has found that the quality of UK asset managers' disclosures on conflicts of interest is often poor.[12] The Commission may wish to consider whether action is required, either to strengthen legal requirements to manage and disclose conflicts of interest, or to improve the quality of their application in practice.

We are pleased that the Commission has raised the question of whether EU rules should require a certain independence of asset managers' governing bodies, eg from parent companies. It is worth noting that fiduciary principles require not just that conflicts of interest are managed, but that they are *avoided* altogether.[13] The 'Big Bang' deregulation, and the subsequent rise of financial services conglomerates, have made this much more difficult to achieve. In our report, we suggest that in attempting to achieve fiduciary standards of care, policymakers must look beyond the legal duties of asset managers and consider also the commercial structures under which they operate. We conclude that *"If [avoiding conflicts of interest] is deemed to be impossible under current business models, there is a need to countenance the possibility that it is the business models and not the fiduciary duties which must be changed."*[14]

8 See FairPensions, 2011, *'Protecting our Best Interests: Rediscovering Fiduciary Obligation'*, p125.
9 See footnote 6
10 Law Commission, 1995, *'Fiduciary duties and regulatory rules'*
11 Myners, 2001, *'Institutional investment in the United Kingdom: A review'*
12 See FairPensions, 2010, *'Stewardship in the Spotlight'*
13 In UK law, see for example Bristol & West Building Society v Mothew
14 FairPensions, 2011, *'Protecting our Best Interests: Rediscovering Fiduciary Obligation'.*

Q17: What would be the best way for the EU to facilitate shareholder cooperation?

In considering this question it is important to be clear on the *purpose* of shareholder co-operation. In our view, this purpose is twofold. Firstly and most obviously, co-operation allows shareholders to exert more influence on their investee companies than they could alone. However, it also has a second and perhaps more neglected purpose: it allows shareholders to address macroeconomic or systemic *issues* which they certainly could not influence alone, through engagement both with companies and with policymakers or regulators.

As discussed above, it is increasingly clear that macroeconomic and systemic issues – whether it be climate change or systemic financial risk – have a highly significant impact on outcomes for beneficiaries. Yet investor engagement on these issues remains relatively weak. In the UK, such engagement may even be thought to be legally risky, following the landmark case of Cowan v Scargill, in which a pension fund's policy of excluding certain investments was held to be unlawful, in part because the fund was too small to have an impact by its actions alone.[15] This means that collaborative engagement is an essential tool to allow investors to address these increasingly vital issues. These issues are considered in detail in Chapter 4 of our report (pp 91-94).

We are sympathetic to the view that EU rules on acting in concert may hinder effective shareholder co-operation, and would support measures to address this provided that they do not undermine the original intent of the legislation.

But rules on acting in concert are clearly not the only thing holding back greater shareholder co-operation. There is also a broader need to address the *willingness* of institutional investors to engage collectively, including on macroeconomic and systemic issues. As regards the establishment of shareholder co-operation fora, we note that successful fora do already exist, for example the UNPRI (Principles for Responsible Investment) Engagement Clearinghouse,[16] and the Institutional Investors' Group on Climate Change.[17] We would support measures to encourage wider use of these existing mechanisms, or to replicate such models on a wider and more accessible scale. However, it is also important to ensure that they do act as a forum for genuinely meaningful and productive engagement on the issues that matter for beneficiaries.

Q18: Should EU law require proxy advisors to be more transparent, e.g. about their analytical methods, conflicts of interest and their policy for managing them and/or whether they apply a code of conduct? If so, how can this best be achieved?

Q19: Do you believe that other (legislative) measures are necessary, e.g. restrictions on the ability of proxy advisors to provide consulting services to investee companies?

We agree with the Commission that the influence of proxy advisors is significant and that this influence should entail some accountability. We also agree that the criteria on which

15 Cowan v Scargill [1984] All ER 750; [1985] Ch 270.
16 See http://www.unpri.org/collaborations/
17 Http://www.iigcc.org

recommendations are based may not be sufficiently transparent – one recent study suggested that following proxy recommendations, far from adding value, may in fact reduce performance.[18] As such, we would support measures to improve transparency regarding analytical methods, and to require conflicts of interest to be managed and disclosed, along similar lines to the requirements currently imposed on asset managers under MiFID. (However, see also our response to Q17 above in which we suggest that these requirements may themselves need to be strengthened.)

However, we would also point out that a more critical attitude to proxy recommendations by investors might be the most effective way of improving accountability and enhancing the quality of voting decisions. The Commission is right to note that "investors with highly diversified equity portfolios face practical difficulties in assessing in detail how they should vote" (para 2.5). Investors cannot be expected to scrutinise every recommendation they receive. However, we believe that they can and should scrutinise recommendations in relation to particularly contentious votes. Evidence from the IMA's recent survey of UK asset managers suggests that, at present, such scrutiny may only be applied to recommendations to vote against management.[19] In the UK, the most recent AGM season saw at least one instance where different proxy agencies made conflicting recommendations (i.e. some for management, some against) on a contentious issue. We believe that, in such cases, investors should not blindly follow the recommendation of their proxy advisor but should scrutinise the issue themselves, regardless of whether their advisor recommends for or against. Thus, although we would support measures to improve the transparency and accountability of proxy advisors, non-legislative measures are also needed to discourage investors from simply 'rubber-stamping' proxy recommendations.

We would also suggest that some of the issues the Commission identifies may apply equally to investment consultants. In the UK, trustees of occupational pension schemes are legally obliged to take advice from consultants when making certain key decisions.[20] Like proxy advisors, investment consultants exercise significant influence on key decisions which determine the effectiveness of stewardship: voting decisions in the case of proxy advisors, and selection of asset managers in the case of investment consultants. In both cases, institutional investors may not be in a position to challenge the recommendations they receive, granting enormous power to these advisors. Yet neither are robustly regulated as regards duties to act in clients' best interests or to manage and disclose conflicts of interest.

The decisions advised on by investment consultants – such as asset allocation and manager selection – are increasingly understood to have a far greater impact on outcomes for beneficiaries than recommendations about individual stocks or funds.[21] Yet the definition of 'investment advice' under MiFID potentially excludes this kind of advice from any meaningful regulation.[22] These issues are considered in detail in Chapter 2 of our report (pp 40-43). We would urge the Commission to consider these wider issues around the regulation of investment advice before taking forward any specific measures regarding

18 Larcker, David F., McCall, Allan L. and Ormazabal, Gaizka, *'Proxy Advisory Firms and Stock Option Exchanges: The Case of Institutional Shareholder Services'* (April 24, 2011). Rock Center for Corporate Governance at Stanford University Working Paper No. 100. Available at SSRN: http://ssrn.com/abstract=1811130

19 IMA, 2011, '*Adherence to the UK Stewardship Code as at 30 September 2010'*, p13-14

20 The Occupational Pension Schemes (Investment) Regulations 2005, SI 2005/3378, regulation 2(2). See also p41, *'Protecting our Best Interests'*

21 See for example See for example Brinson et al, 1991, *'Determinants of Portfolio Performance II: An Update'*, Financial Analysts Journal vol 47, no. 3 (May/June): 40-48; Ibbotsen, *'The Importance of Asset Allocation'*, Financial Analysts Journal Vol 66 No 2 (March/April 2010)

22 Markets in Financial Instruments Directive, Article 4(4)

proxy advisors.

Q20: Do you see a need for a technical and/or legal European mechanism to help issuers identify their shareholders in order to facilitate dialogue on corporate governance issues? If so, do you believe this would also benefit cooperation between investors? Please provide details (e.g. objective(s) pursued, preferred instrument, frequency, level of detail and cost allocation).

We cannot comment from the perspective of issuers as this is not our area of expertise. However, we do believe there is a case for greater transparency in this area from the perspective of ultimate owners, such as pension savers. That is, beneficiaries should be able to more easily determine whether their pension is invested in a given company. Transparency to beneficiaries allows demand for effective stewardship to be transmitted up the investment chain, as well as enabling those whose money is at stake to hold their agents to account for their ownership practices. In our recent response to the UK government's consultation, *'A long-term focus for corporate Britain',* we commented:

> "*We do believe there is a case for wider transparency about the ownership of publicly listed companies. Currently some information is available in principle if someone makes an appointment with the company secretary's office to view the share register. In addition information about major shareholders is disclosed in the Annual Report. However, it is generally impossible to identify the beneficial owners, as opposed to nominees. This means that ultimate owners lack visibility on the equity holdings of their pension funds. We find ourselves dealing with enquiries from fund members as to whether their pension fund is invested in a particular company, something they cannot find out either from their fund or from the share register."*[23]

The comply-or-explain framework

Q24: Do you agree that companies departing from the recommendations of corporate governance codes should be required to provide detailed explanations for such departures and describe the alternative solutions adopted?

Q25: Do you agree that monitoring bodies should be authorised to check the informative quality of the explanations in the corporate governance statements and require companies to complete the explanations where necessary? If yes, what exactly should be their role?

We agree that corporate governance statements are not always monitored as they should be, either by investors or by regulators, and that the quality of explanations is consequently often poor. A 2005 study by the London School of Economics found that firms who did not comply with the Combined Code of Corporate Governance "*often did a very poor job explaining themselves*", with almost one in five cases of non-compliance not explaining themselves at all. Moreover, the study concluded that *"shareholders seem to be indifferent to the quality of explanations",* and that *"ways to foster shareholders' attention to*

23 Our full response is available online at http://www.fairpensions.org.uk/sites/default/files/uploaded_files/LongTermismResponse01-11.pdf

explanations have to be found."[24]

The UK's Combined Code has of course been replaced by the Corporate Governance Code and the Stewardship Code, with the latter being introduced specifically to address the shareholder indifference which this study highlighted and which the financial crisis exposed as a public policy issue. The Stewardship Code guidance suggests that asset managers should disclose their approach to company 'explanations' for non-compliance with the Corporate Governance Code. When we surveyed UK asset managers' disclosures under the Code, this was a particular area of weakness: *"Many of the asset manager statements on this important issue were platitudinous and offered no insight on the rigour of their approach to explanations."*[25] Notwithstanding the promising improvements generated by the Stewardship Code in other respects, we would therefore suggest that there is a long way to go in this area, and that the conclusions reached about comply-or-explain by the LSE study in 2005 may still be broadly accurate today.

The primary enforcement mechanism for corporate governance codes is shareholder oversight. We continue to work within the UK to encourage such oversight, and we hope that the UK Stewardship Code, and the development of similar initiatives in other member states, will over time produce the necessary culture change to render this enforcement mechanism effective.

If such efforts ultimately prove ineffective, it may be necessary to consider other methods of enforcement in order to uphold the integrity of 'comply-or-explain'. It is important to bear in mind that the corporate governance framework exists not just to protect the institutional shareholders who are responsible for overseeing it, but also to protect their end-beneficiaries, who often have little or no control over the institution's activities. If institutional shareholders are not performing this function, it is therefore legitimate for regulators to step in to ensure that their beneficiaries are adequately protected. As such, we would support measures to empower regulators to oversee the quality of firms' explanations rather than simply verifying that a statement has been published. This would provide national regulators with a 'reserve power' in the event that shareholders do not rise to the challenge of ensuring that corporate governance is monitored effectively.

We believe that it would be possible for regulators to exercise this power without undermining the principle of managerial discretion, since judgements would be made about the quality of explanations rather than on the substantive question of whether non-compliance is justified. Likewise, we do not believe that this power would restrict the discretion of shareholders in relation to their monitoring of investee companies. We have previously argued that the UK Stewardship Code should specifically provide that an unjustifiable breach of the UK Corporate Governance Code by an investee company is a ground for shareholder intervention. We think that this suggested provision should extend to cases where the regulator has criticised the quality of an explanation for non-compliance with the Corporate Governance Code. Shareholders would retain an undiminished discretion whether or not to intervene.

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24 Arcot, Bruno & Grimaud, 2005, *'Corporate Governance in the UK: Is the comply-or-explain approach working?'*
25 FairPensions, 2010, *'Stewardship in the Spotlight'*, p9