Submission to the European Commission Green Paper
‘Corporate governance in financial institutions and remuneration policies’
(COM(2010)285 final)

August 2010
About FairPensions

FairPensions is the operating name of Fairshare Educational Foundation, a UK registered charity that aims to encourage pension funds and fund managers to adopt an effective responsible investment (“RI”) capability, exercising their shareholder rights to monitor and manage extra-financial risks with the potential to affect long-term financial returns.

We work to promote responsible shareholder engagement through dialogue, reinforced by the potential exercise of shareholder powers. FairPensions believes that RI practices help to safeguard investments and to promote better corporate governance, as well as securing other environmental and social benefits.

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 and about our approach to RI can be found on our website: http://www.fairpensions.org.uk.

Introductory remarks

We respond below to the consultation questions which are relevant to our remit. However, we would first like to make some introductory remarks and to comment on certain aspects of the consultation paper which do not correspond to specific questions.

FairPensions is pleased to have the opportunity to respond to this timely consideration of the need to strengthen corporate governance arrangements in banks and financial institutions. FairPensions' own focus is on scrutiny by institutional investors of companies' governance arrangements and risk management. It is now well-accepted that the failure of many investors to exercise such scrutiny was a key contributor to the financial crisis. Risky business models and poor decisions went unchallenged, with devastating consequences for pension savers, particularly those heavily exposed to equities.

Clearly, the response to these failures cannot be limited either to banks and financial institutions themselves or to their investors: if we are to avoid a repeat of the financial crisis, there is an urgent need to instil a culture of responsibility and long-termism at all stages of the investment chain.

In this context, we particularly welcome the Commission's decision to undertake a broader review of corporate governance within listed companies and of the role of shareholders. As the governance model in the banking sector is essentially the same as in the rest of the listed sector, both at board and institutional shareholder level, it seems clear that the failings of the banks have wider implications. Even those features that are most characteristic of investment banking, such as a bonus culture and complex products, are not unique to that sector. Perhaps the only fundamental difference is the systemic importance of the banks, which, although it makes their governance failures more damaging, does not diminish the more general relevance of the flaws that have been exposed.

We strongly agree with the reasons put forward for the 'implementation gap' between existing corporate governance principles and application. In particular, we concur that the existence of principles which are “too broad in scope and are not sufficiently precise” has
encouraged “box-ticking”. In the UK, we have observed a worrying trend for policymakers and supervisory authorities – often at the behest of industry – to eschew 'prescriptive' regulations on the basis that they will encourage 'box-ticking' and will not deliver the necessary cultural change. We agree with the view outlined in the consultation paper that, in fact, the reverse is true: vague, high-level principles are more likely to produce formal compliance that does not meaningfully address the underlying issues at stake.

We also agree that the non-binding nature of corporate governance codes is a problem. We are concerned by the persistent unwillingness to regulate in the UK context, and by the continued reliance on a 'comply or explain' approach which fails to guarantee that minimum standards are being observed by all market participants. While we agree that regulation should neither be pursued for regulation's sake, nor assumed to be a panacea for endemic cultural problems within the industry, it seems clear that intelligent regulation must be part of the response.

In the aftermath of the financial crisis, few would deny the existence of a public interest in the behaviour both of the boards of banks and financial institutions, and of their shareholders. We feel it is important for the Commission to explicitly confirm this public interest dimension. Such confirmation would help overcome the understandable unwillingness within the industry to accept that public interest considerations have a legitimate place in reforming corporate governance arrangements.

Boards of Directors

Q1.5: “Should a compulsory evaluation of the functioning of the board of directors, carried out by an external evaluator, be put in place? Should the result of this evaluation be made available to supervisory authorities and shareholders?”

Yes. We supported Sir David Walker's recommendation that UK banks and financial institutions should undertake regular, externally facilitated evaluations of the board of directors. We would welcome the adoption of this principle at EU level. In our submission to the Walker Review, we raised a number of particular points about the implementation of external evaluations, namely that:

- In no circumstances should the external evaluator have any other business relationship with the company or be permitted to have one for a substantial period (at least five years) after the evaluation. The importance of the evaluation for board members and the extreme sensitivities involved would constitute a completely unacceptable conflict of interest.
- For similar reasons, the external evaluator should not be appointed by the board but by the shareholders.
- A statement about the results of the evaluation should be provided in companies’ annual reports. The external evaluator should attest the accuracy of this evaluation.

1 COM(2010) 284 final, page 6
statement (a safeguard which the Walker Review unfortunately rejected). We believe this is essential in an area where the board members could have a clear conflict of interest.

- There should be provision for an advisory vote on the evaluation statement, providing an opportunity for shareholders to signal any concerns they might have about the results of the evaluation.

As the above makes clear, we feel that if a compulsory evaluation is introduced, it is imperative that the results be made available to shareholders. It is vital that shareholders have access to independently verified information about the position of the company and the performance of the board. (See also our response to Q3.3.)

Q1.6 & Q1.10:

- “Should it be compulsory to set up a risk committee within the board of directors and establish rules regarding the composition and functioning of this committee?”
- “Should a risk control declaration be put in place and published?”

We agree with both of these proposals: it is vital that the status of risk management functions within financial institutions is enhanced, and that better information about significant risks and steps being taken to manage them is provided to shareholders. If shareholders are to be expected to engage in the more active scrutiny which is generally agreed to be necessary, they must be provided with the tools to do so. We also agree that it would be appropriate for risk control declarations to be published, rather than simply made available on request to shareholders, given their systemic importance and the significant public interest in effective risk management. In this regard we would also draw attention to our response to the Walker Review's recommendations on risk management in UK banks and financial institutions.4

We particularly agree with the Commission's observation that “financial institutions have too often failed to take a holistic approach to risk management.”5 The Commission's observation that risk management expertise has been too often “limited to those categories of risk considered priorities, and did not cover the entire range of risks to be monitored” is particularly important in this context.6

It is vital that the response to the recent crisis is forward- as well as backward-looking. Of course we must ensure that the particular failings that led to the last crisis cannot be repeated. But improved risk management cannot be limited to this: it must also look ahead, ensuring that the 'categories of risk' that may lead to the next crisis are anticipated, monitored and managed.

We submit that in order to achieve this goal, it is crucial to gain acceptance for the principle that the 'entire range of risks to be monitored' must include potential financial risks caused by non-financial factors – i.e. environmental, social and governance (ESG) risks. Climate change is an obvious example of a systemic ESG issue with significant financial and economic implications that financial institutions will need to manage. In our most recent survey of UK fund managers, 89% of respondents saw climate change as a

5 COM(2010) 284 final, page 7
6 Ibid.
significant investment issue - yet far fewer said that they integrated the management of climate risks into their business practices. Lack of client demand was cited as one of the biggest reasons for this disparity.7 A 2009 report by Mercer & Trucost, ‘Carbon Risks in UK Equity Funds’, replicated these findings: climate change was found to be of little importance in fund managers’ investment decisions.8 There is increasing political concern in the UK about this aspect of risk management. For instance, the UK Parliament’s Environmental Audit Committee recently took evidence on the climate impacts of the partly state-owned banks managed by UK Financial Institutions.9

This body of evidence suggests that, in the UK at least, there is a complacency about climate-related risks among financial institutions and their institutional shareholders which closely mirrors the cavalier attitude to securitisation that preceded the financial crisis. We therefore suggest that any new rules or recommendations regarding the function of board risk committees and the content of risk control declarations should make it clear that boards are expected to take a broad view of the range of risks that might be relevant, and in particular that financially-relevant ESG risks should be included in this. Without such explicit confirmation, neglect of ESG risks is likely to continue.

This is, of course, subject to the caveat that it is foolish to assume one can foresee and identify all relevant risks, particularly when one is trying to predict future risks rather than using past experience as a guide. Attempts to manage ‘Black Swans’10 – the sort of rare, unpredictable, high-impact events that often determine the course of history – are likely to prove futile, and this should always be taken into account in any assessment of the degree of risk to which a bank or financial institution is exposed. There is a danger that relying too heavily on revised risk management processes might give rise to a misplaced confidence that the risks attaching to potential Black Swans were under control when in reality they were not.

Q1.13: “Should a specific duty be established for the board of directors to take into account the interests of depositors and other stakeholders during the decision-making procedure ('duty of care')?”

Yes. We strongly agree with the Commission's view that corporate governance in the financial sector “should take account of the interests of other stakeholders... as well as the stability of the financial system, due to the systemic nature of many players.”11

It is vital that the interests of ultimate asset owners, as distinct from those of institutional investors, are fully recognised and protected throughout the investment chain. Moreover, it is clear that these interests were not well served by many in the investment industry in the run-up to the financial crisis – with savers ultimately bearing the consequences of short-termist strategies and disregard for risk. FairPensions is currently conducting some work on the desirability of extending fiduciary obligations, in the UK context, from pension fund trustees to other actors in the investment chain. We would be pleased to share the resulting report with the Commission once it is available.

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10 The Black Swan: The Impact of the Highly Improbable, Nassim Nicholas Taleb,Penguin, Allen Lane, 2007
The long-term interests of ultimate owners are clearly aligned with the public interest in stable and sustainable value creation. Therefore, we do not believe that the ‘long-term’ interests of depositors and the ‘short-term’ interests of shareholders are as diametrically opposed as the Green Paper appears to suggest. Pension funds and other long-term investors also have an interest in sustainable value creation – as we consider further in our responses to Questions 5 and 5. 4,

We also welcome the Commission’s recognition that “taxpayers are inevitably stakeholders in the running of financial institutions, with the goal of financial stability and long-term economic growth”.12 In this context we note Sir David Walker’s comment, in his Review of Corporate Governance in UK Banks and Financial Institutions, that

“Experience in the recent crisis phase has forcefully illustrated that while shareholders enjoy limited liability in respect of their investee companies, in the case of major banks the taxpayer has been obliged to assume effectively unlimited liability.” 13

We would therefore strongly urge that any consideration of stakeholder duties for boards of directors has regard to the broad range of possible stakeholders, taking into account the public interest dimension. The stakeholder duties in the UK Companies Act14 - which apply to directors of all listed companies – are perhaps a good starting point in this regard, demonstrating how regard for a broader range of stakeholders can be combined with a governance model in which directors’ ultimate responsibility remains to the members of the company. We would welcome the creation of similar duties at EU level.

For instance, Section 172 requires directors to have regard to ‘the impact of the company’s operations on the community and the environment’. In previous submissions at UK level, we have suggested that this could usefully be strengthened to include specifically the impact on the integrity of the financial system and on the economy as a whole.15 We would suggest that, if the Commission is considering additional stakeholder duties at EU level with the aim of improving the financial system’s resilience to future crises, this may be a model worth exploring.

Having said this, we would also note that the enforcement of such stakeholder duties is vital: companies must clearly demonstrate that they are taking them into account. In our experience, the application of the UK legislation by listed companies has been inconsistent. We would therefore urge the Commission to give serious thought to the enforcement arrangements for any new ‘duties of care’ or other stakeholder duties.

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12 COM(2010) 284 final, page 4
Risk-related functions

Q2.1: “How can the status of the chief risk officer be enhanced? Should the status of the chief risk officer be at least equivalent to that of the chief financial officer?”

At UK level, we supported the Walker Review’s recommendations regarding the role of the Chief Risk Officer (CRO), namely that

“Alongside an internal reporting line to the CEO or FD, the CRO should report to the board risk committee, with direct access to the chairman of the committee in the event of need. The tenure and independence of the CRO should be underpinned by a provision that removal from office would require the prior agreement of the board. The remuneration of the CRO should be subject to approval by the chairman or chairman of the board remuneration committee.”16

It is vital that the risk control function is not marginalised, but recognised as a core function of the board of directors. We therefore agree that the CRO’s status should be at least equivalent to that of the Chief Financial Officer. We note the recent report by the UK’s Association of Chartered Certified Accountants (ACCA), which notes that “a corporate culture can render the compliance and risk management functions totally impotent”. ACCA argues that the best CROs “try to influence the culture for the benefit of the company”, and that “the Chief Financial Officer (CFO) is the member of the board best placed to influence the culture positively.”17 We would agree that the CRO must be a sufficiently senior member of the board to influence the culture in this way.

External auditors

Q3.3: “Should external auditors' control be extended to risk-related financial information?”

We agree with the Commission that it would be desirable for external auditors “to validate a greater range of information which is relevant to shareholders than ... at present in order to improve investor confidence in this type of information, thereby encouraging the proper functioning of the markets.”18 If shareholders are to take on the active and responsible approach to ownership which, as the Commission notes, was lacking prior to the recent financial crisis, it is vital that they are provided with independently verified, reliable information about investee companies' risk exposure. It is certainly our experience that asset managers do not feel the current level of information they are provided with is sufficient to enable them to assess their investee companies’ risk exposure, and that some kind of audit procedure is an essential part of the solution.

It would be unthinkable for a company to release unaudited accounts to its shareholders. We believe that the same should apply to all information about the principal risks facing a company, including 'narrative reporting'.

The UK government is currently consulting on proposals to reintroduce an Operating and Financial Review (OFR) for UK-listed companies, whereby directors report on the

18 COM(2010) 284 final, page 14
principal risks and uncertainties facing the company – including social and environmental
risks. A key plank of the previous OFR regime was the enhanced audit, and we will
support its reintroduction as part of the new UK reporting regime. We would support any
similar moves at EU level, whether for financial institutions or for all listed companies.
Reliable information about risk is crucial to the prevention of future crises, and it is
difficult to see any reason, other than precedent, why this should not apply to narrative as
well as financial information.

We recognise that there are significant unresolved issues surrounding the audit profession
itself. The financial crisis itself has prompted greater scepticism about the value of audit.
Audited accounts prior to the crisis failed to identify the systemic risks facing almost every
major European bank. The UK’s Financial Services Authority and Financial Reporting
Council recently issued a discussion paper on this matter, noting that:

“In some cases the FSA has seen concerning valuations, provisions and disclosures, the
auditor’s approach seems to focus too much on gathering and accepting evidence to
support managements’ assertions, and whether managements’ valuations and
disclosures comply with the letter of accounting standards, rather than whether the
standards’ requirements have been applied in a thoughtful way that would better meet
the standards’ objectives. In some areas, it can be questioned whether auditors always
exhibit sufficient professional scepticism.”

The Chief Executive of the Financial Reporting Council has also identified the fact that
“shareholders are remote from audit, [while] management are in the room” as a barrier
to auditors fulfilling their role of providing an independent voice of challenge.

There is clearly work to be done to tackle conflicts of interest and enhance the effectiveness
of external audit. However, we wish to be clear that these concerns should not be invoked
as justification for opposing the expansion of audit requirements. It is vital that all risk-
related information is reliable and independently verified. Expanded audit requirements
and a more effective audit profession are both necessary conditions for achieving this
regulatory objective.

**Shareholders**

**General question 5:** “Interested parties are invited to express their view on
whether they consider that shareholder control of financial institutions is still
realistic. If so, how in their opinion would it be possible to improve
shareholder engagement in practice?”

The Green Paper questions whether the reliance of corporate governance rules on
shareholder oversight is still appropriate. We believe that effective, responsible
shareholder oversight of financial institutions is possible. However, it must be made clear
that the track record of most investors in this respect is unacceptable, and that if investors
expect to retain their dominant role in the corporate governance of financial institutions,
they must urgently demonstrate their willingness to rectify this neglect.

future-of-narrative-reporting-a-consultation

contribution to prudential regulation’ (June 2010)

21 Stephen Haddrill, ‘Should statutory audit be dropped and assurance needs left to the market?’ (Speech at the
ICAS Aileen Beattie Memorial Event, 28 April 2010)
We are pleased to note that the Commission’s Green Paper itself is being regarded by some UK investors as a strong signal that shareholders must take more responsibility.\(^{22}\)

We recognise that the increasingly diversified shareholder base of financial institutions presents challenges. However, we do not entirely agree with the Green Paper’s suggestion that “shareholders benefit from a rise in the share price and maximisation of profits in the short term and are potentially less interested in too low a level of risk.”\(^{23}\) Whilst this may be true of certain types of investors, it is not true of long-term investors, such as pension funds, who are still highly significant actors.

Recent examples – such as the collapse of Prudential’s takeover bid for AIG – demonstrate that concentrated shareholder action can still impact major corporate decisions. Of course, it is important to recognise that this impact can be positive or negative. The contribution of shareholders to the financial crisis arose not simply from a failure to engage – the ‘ownerless company’ problem – but also from the active influence of short-termist investors. Here, shareholder engagement clearly exacerbated governance failures rather than mitigated them.

The regulatory challenge is therefore not simply to encourage shareholders to engage, but to encourage responsible engagement by investors whose priorities accord with the long-term interests of financial institutions and the economy at large. Given the increasingly international ownership of major financial institutions, we would therefore welcome greater European leadership on this issue. For instance, a pan-European Stewardship Code might do more to improve levels of shareholder engagement than the various disparate national initiatives currently taking place – of which the UK’s has been the first. (See also our answer to Question 5.2.)

Q5.1: “Should disclosure of institutional investors' voting practices and policies be compulsory? How often?”

FairPensions has long argued for mandatory public disclosure of voting records by institutional investors. Such disclosure should be at least annual, and ideally quarterly.

There is some evidence that the existing French and American requirements regarding disclosure of voting practices have been effective in driving up the level and quality of shareholder engagement. In 2009, shareholder voting turnout at European company AGMs rose above 50% for the first time.\(^{24}\) Sarah Wilson, the chief executive of Manifest UK, has argued that the increased shareholder voting turnout is not just due to the financial crisis, but “included disclosure of share-voting records being made compulsory for U.S. mutual funds a few years ago and for certain French funds last year.”\(^{25}\)

Voting information is also important for market participants – including the clients of institutional investors and their ultimate beneficiaries. In the interests of transparent markets, ultimate asset owners should have the right to know how the shareholder rights attaching to their investments are being exercised – but, in the UK at least, this is currently far from being the case.

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\(^{23}\) COM(2010) 284 final, page 4

\(^{24}\) Directorship, *Need to Know: European Investors get the world out*, (November 2009), page 10.

\(^{25}\) Ibid.
Our research into UK pension funds has highlighted a persistent transparency problem throughout the investment chain. The problem is two-fold: firstly, the majority of pension funds blindly delegate voting decisions to their fund manager, and often do not find out how their fund manager has voted or intends to vote. Secondly, pension funds themselves rarely disclose voting information to their members – our most recent survey of the 30 largest UK pension funds found that only five disclosed full voting records – and pension savers who enquire about particular voting decisions are often met with hostility. (This highlights a further distinction which the Commission may wish to consider: between compulsory retrospective disclosure of voting behaviour, and compulsory disclosure of voting intentions. It is clearly desirable that savers should be able to inquire about their fund’s intentions regarding a controversial vote. Yet at present, there is no requirement that such information be disclosed on request.) There is a need to improve both pension funds’ access to information from their fund managers, and pension savers’ access to information from their pension funds. Mandatory public disclosure for institutional investors would achieve both of these objectives.

As the Commission recognises, in the aftermath of the financial crisis, there is clearly also a public interest in how shareholder oversight of major companies is being exercised. Again, this makes it all the more important that compulsory disclosure of voting practices should mean public disclosure on public websites, and not only disclosure to clients. And again, this applies to pension funds as well as to those who manage their money. Pension funds are still among the most important allocators of capital in the world. It therefore seems anomalous that, although the activities of institutional investors in general are increasingly regarded as a matter of public interest, there is still an assumption that the activities of pension funds are a matter for their members alone.

Since asset managers already record detailed information on voting decisions internally, the costs of compulsory public disclosure would not be prohibitive - the actual publication of the data on investors’ websites seems a small additional burden to impose relative to the benefits in transparency that such a requirement would bring. We also reject the argument made by some investors that it is vital to their operations that such engagement remains confidential. The scattered examples of best practice belie this argument, since clearly these investors would not disclose if they felt that it was damaging to their business.

Although in 2006 the UK government took a reserve power to require such disclosure, this power has yet to be exercised. There has been some suggestion that any mandatory requirements should be delayed to allow for the development of voluntary codes of practice. FairPensions believes this would be a mistake. If anything, the UK experience is an indication that voluntary frameworks on voting disclosure are unlikely to have the desired impact. Voting disclosure has been recognised as best practice in numerous voluntary codes. In 2007 the Institutional Shareholders Committee published a voluntary framework on voting disclosure. In 2008, the National Association of Pension Funds’ (NAPF) annual engagement survey found that only 24% of UK pension funds disclosed any information on voting specifics to their members, and only 7% disclosed full voting information. As the report noted, “we would not expect [the ISC framework] to have had
a material effect on voting disclosure in this year's survey”,
so this provides a benchmark against which to measure the success of this particular code. In this year's survey, the percentage of funds disclosing voting information to their members was identical: 24%. Even fewer – 21% - disclosed such information publicly.

Three years on from the publication of the ISC framework, there is little evidence that levels of disclosure are improving.

We have little reason to think that the new UK Stewardship Code – already being talked of as a model for 'comply or explain' codes in other European countries – will change this situation much, in part because its guidance on voting disclosure is somewhat ambiguous as to whether disclosure is actually required.

Another fundamental problem with voluntary frameworks is that they tend not to produce comparable information. Among UK institutional investors who do disclose their voting records, there is currently huge variation in exactly what information is disclosed, and in what format. At the upper end of the spectrum, a small number of fund managers (such as F&C) disclose full details of every vote cast, including the company, the issue, and the reason for the voting decision. At the other end of the spectrum, many fund managers disclose only very basic aggregated details – such as the number of votes cast in the course of a year, and the percentage cast for or against management.

Such information is of very little use in tracking engagement on particular strategic issues. Yet the UK Stewardship Code makes no distinction between these two extremes of disclosure. We are currently working on our biennial transparency survey of UK fund managers, and will be pleased to share the results of this research with the Commission once available.

In arguing against UK-level regulation, some investors have expressed concern that the multiplication of different disclosure standards in different jurisdictions could prove burdensome in today's global marketplace. EU regulation seems the obvious answer to this objection: common standards would provide greater clarity and consistency for investors, making the requirements simpler to apply. Given that so many financial institutions are transnational or able to migrate easily between jurisdictions, it would also significantly further the ultimate objective of promoting responsible shareholder engagement in the interests of global financial stability. FairPensions believes that, in response to the financial crisis, it is vital that the EU follows the USA's lead on this issue.

Q5.2: “Should institutional investors be obliged to adhere to a code of best practice (national or international) such as, for example, the code of the International Corporate Governance Network (ICGN)?”

We believe that codes of practice can be useful starting points for improving the mainstream integration of responsible shareholder engagement. At a UK level, FairPensions has previously supported proposals to give statutory encouragement for the UN Principles for Responsible Investment. We would also reiterate the point made in

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31 NAPF, 'Pension funds' engagement with companies 2010'.
34 See for example http://www.assetmanagement.hsbc.com/uk/institutions/corporate_gov.html
35 See Commons debate on proposed amendment to the Pensions Bill (22 Apr 2008: Col 1259), available online at http://www.publications.parliament.uk/pa/cm200708/cmhansrd/cm080422/debtext/80422-0015.htm#080422109000154
our response to General Question 5 above: given the international nature both of major financial institutions and of their shareholder base, a common European standard – whether it be an endorsement of an existing code, such as that of the ICGN, or a new ‘European Stewardship Code’ – would have clear advantages over the emerging proliferation of national Codes. A single Code would provide clarity for shareholders regarding expected minimum standards, and greater simplicity for all market participants. This has the potential to significantly improve the uptake and quality of engagement.

However, for the reasons given above (see our response to Question 5.1), we have reservations about the effectiveness of codes of best practice. If the Commission feels that there are sufficient grounds for obliging investors to adhere to high standards regarding their ownership responsibilities, our preference would be for statutory guidelines which clearly set out the standard to be met, and ensure that any reporting is comparable and meaningful.

Q5.4: “Which other measures could encourage shareholders to engage in financial institutions' corporate governance?”

If shareholders are to be encouraged to engage more actively, they must be given the tools to scrutinise the financial institutions in which they invest. As noted in our response to Q3.3, meaningful, accurate and verifiable information about key strategic risks – including governance and other non-financial risks – is a crucial part of this toolkit. If shareholders are to engage on such issues in the same way that they would on a major financial issue, they must have equal confidence in the information available. We therefore support strong narrative reporting requirements, including appropriate provision for the auditing of such strategic information. We trust that this will be reflected in the upcoming reconsideration of the Accounts Modernisation Directive.

In turn, asset managers must be made more accountable to ultimate asset owners and other stakeholders for their engagement activities. Our research suggests that asset managers regard lack of client demand as one of the major barriers to increased engagement.39 We would suggest that such demand is likely to come from ultimate asset owners, i.e. savers and pension fund members. The length and complexity of investment chains, coupled with a lack of transparency, mean that these consumers’ preferences are not currently being transmitted up the investment chain. In order for market mechanisms to work, consumers' capacity to voice and act on their preferences must be enhanced. Much of FairPensions' work involves educating pension fund members about the rights attaching to their investments, and facilitating them to question their funds about the exercise of these shareholder rights. In this regard, we would suggest that any consideration of compulsory disclosure of voting records should encompass consideration of disclosure requirements on engagement activities more generally.

We would also note that it is not just a matter of encouraging shareholders to engage, but of encouraging the right kind of engagement. We should like to comment here on the suggestion made by Lord Myners41 that, because of the public interest case for increasing the influence over corporate governance of long-term investors, such investors might be accorded some form of preferential voting rights.

41 Financial Times, 13 August 2009
This idea has scarcely been greeted with universal acclaim and we appreciate the difficulties which it raises. One possible alternative might be to accord preferential voting rights to those long-term investors who adhere to codes of best practice regarding investor stewardship (see our response to Question 5.2).

**Remuneration**

Q7.4: “Do you think that the role of shareholders, and also that of employees and their representatives, should be strengthened in establishing remuneration policy?”

In our UK policy submissions, we have advocated statutory provision to make the shareholders’ advisory vote on remuneration binding. Sir David Walker’s Review of Corporate Governance rejected this idea on the basis that the remuneration report “relates to effectively contractual commitments given to executives within the framework of a policy already implicitly or explicitly approved by shareholders”.

We do not accept that this is an insuperable barrier to reform. For example, it could be provided that all such contractual commitments were subject to shareholder confirmation; appropriate provisions for adjustment in the event of shareholder approval being withheld could also be devised. In any case, if the remuneration in question were clearly within the framework already approved by shareholders, it is presumably unlikely that it would be rejected; it is when this is not so apparent that there is likely to be concern.

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 resign.

**Conflicts of interest**

General question 8: “Interested parties are invited to express whether they agree with the Commission’s observation that, in spite of current requirements for transparency with regard to conflicts of interest, surveillance of conflicts of interest by the markets alone is not always possible or effective.”

We agree. Regulation has a crucial role to play in setting the rules of conduct for market participants, particularly where conflicts of interest are concerned. From auditors carrying out non-audit functions to proprietary trading, conflicts of interest are clearly a pervasive problem in the financial sector, and one of the key barriers to tackling the governance failures that led to the financial crisis. There is little reason to suppose that the markets are capable of managing or preventing these conflicts. FairPensions believes that tackling conflicts of interest must therefore be one of the key objectives of any review of the corporate governance framework.

Where possible, regulation should aim to set down rules that prevent conflicts of interest

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from arising in the first place, rather than managing them when they do arise. As well as being more effective, such an approach can reduce burdens both on regulators and regulated entities: once permitted relationships have been established, there is less need for intrusive ongoing supervision.

Certainly, measures which empower responsible investors and ultimate asset owners, as discussed above, will allow them to take more effective action to challenge and remedy conflicts of interest. In this sense, there is room to improve the effectiveness of the market under current transparency requirements. However, we believe it is self-evident that this must be a supplement to effective regulation rather than a substitute for it.