



***Kay Review Call for Evidence:
Response from FairPensions***

November 2011

About FairPensions

FairPensions is a registered charity that promotes Responsible Investment (RI) by pension schemes and fund managers. RI generally involves shareholder engagement with companies to ensure that environmental, social and corporate governance (ESG) risks with the potential to affect long-term financial returns are monitored and managed.

FairPensions publishes research including widely-respected industry benchmarking surveys. Our single-issue campaigns help turn the spotlight onto hitherto neglected areas where there is a strong business case for investor engagement. We also work with policymakers to improve transparency and accountability to savers, and to remove regulatory barriers to RI.

We are a member organisation, whose members include representatives of pension savers (such as the National Federation of Occupational Pensioners, UNITE and Unison), a number of leading UK charities (including Oxfam, Amnesty International and WWF), and thousands of individual pension fund members. We are independent of industry and are funded primarily by grants from charitable foundations and trusts.

Summary

In theory, pension funds are in a unique position to take a long view and to act as providers of 'patient capital' in the interests of their beneficiaries. Yet in practice, there is significant evidence – including from pension funds themselves – that their time horizons are shorter than would be ideal.

Clearly, the reasons for this are complex and there is no simple solution. Our recent research has focussed on one part of the picture which our experience suggests is significant: agency problems in the investment chain and the functionality or otherwise of the legal structures designed to manage them.

There is an obvious alignment between the interests of savers and those of the companies their money is invested in, to the extent that both will benefit from a stable, strong economy and from investors who focus on long-term sustainable value creation. Yet this common-sense link has been broken by misaligned incentives throughout the investment chain, together with the pervasive myth of a 'fiduciary duty to maximise returns'.

Pension fund investments suffer from a 'double agency' problem: savers entrust their money to pension funds who in turn entrust it to asset managers. The relationship between savers and their pension funds (or, increasingly, their commercial pension providers) is often neglected in corporate governance debates. Yet the disconnect between ordinary savers and decisions about their money is important: it impedes the functioning of an effective market, and contributes to misalignment of interests. Savers who do take an interest in how their money is being managed, including in the exercise of ownership rights, often encounter resistance from those managing their savings and generally receive inadequate information.

Pension fund trustees increasingly delegate their powers, but cannot delegate their fiduciary responsibilities. Often lacking expertise, trustees are increasingly dependent on agents and advisors whose own duties are unclear. Funds seek to hold their asset managers to account by regularly judging their performance against the benchmark, creating perverse incentives to maximise short-term returns and ignore long-term risks and opportunities.

Ironically, this trend is exacerbated by narrow interpretations of trustees' fiduciary obligations, which exist precisely to deal with the dangers inherent in principal/agent relationships. Interpretations of investors' fiduciary duties have lost sight of the fund's overall objective of providing beneficiaries with a decent standard of living in retirement, and instead become fixated on a narrow idea of short-term profit maximisation. In addition, the courts have interpreted 'prudent' investment in relation to the behaviour of other similar investors, inadvertently encouraging benchmark-orientated strategies and discouraging independent thought. Trustees are personally liable for breach of fiduciary duties, making many fearful of departing from the safety of the herd – an outcome which has been described as 'reckless caution'.

The idea that investors' duty to their beneficiaries begins and ends with maximising quarterly returns helps to explain the relative failure of the Companies Act 2006 to promote more long-term, responsible company behaviour. Put simply, the Companies Act's ethos of 'enlightened shareholder value' relies on the presence of enlightened shareholders. The basic duty of company directors is to promote the success of the company in the interests of its shareholders. If shareholders interpret their own duty to their beneficiaries as the maximisation of short-term return, it is hardly surprising that this imperative will be transmitted along the chain to directors. We therefore suggest that there is a need to revisit section 172 and consider a parallel provision for institutional investors themselves, which would clarify the scope of fiduciary obligations and dispel misconceptions which have become dysfunctional.

In the remainder of this document we respond individually to the questions relevant to our remit and expertise.

1. Whether the timescales considered by boards and senior management in evaluating corporate risks and opportunities, and by institutional shareholders and asset managers in making investment and governance decisions, match the time horizons of the underlying beneficiaries.

Questions a)-c) fall largely outside our area of expertise as they concern the behaviour of corporate boards and management. We therefore focus on question d):

What timescales are used by equity investors, and in particular institutional investors such as pension scheme trustees, who appoint fund managers in determining investment strategy.

In theory, pension funds are in a unique position to take a long view and to act as providers of 'patient capital' in the long-term interests of their beneficiaries. Of course, not all beneficiaries have the same time horizons: older members on the verge of retirement may actually have an interest in short-term investment thinking. But pension fund trustees have a fiduciary duty to act impartially between classes of beneficiary, and this should include impartiality between younger and older beneficiaries. Some academics, notably Keith Johnson and Keith Ambachtsheer,¹ argue that this duty is currently being poorly fulfilled: the short timescales used in investment decision-making overwhelmingly favour older beneficiaries, while the longer-term considerations which will affect younger beneficiaries but may not have a demonstrable impact on quarterly returns – including environmental, social and governance (ESG) factors – are neglected. Younger pension savers tend to be poorly represented on boards of trustees.

In our experience, many pension scheme trustees admit that the timescales used in their investment decision-making are shorter than would be ideal and do not match the timescale of their liabilities. This is supported by survey evidence at a European level, suggesting the problem is not confined to the UK. For example, a 2008 study of ten European pension funds representing over €460bn in assets² found that:

- ▲ On average, the funds estimated their own ideal investment horizons at 23 years, and their actual investment horizons at just six years.
- ▲ There was very high agreement that 'most investors act in too short-term a manner'
- ▲ Participants felt that short-term, benchmark-relative remuneration structures were partly to blame for this

Our own research also suggests that the short timescales used by equity investors (both asset owners and asset managers) may impede consideration of longer-term determinants of return. For example, in our 2009 survey of UK asset managers, *'Preparing for the Storm: UK fund managers and the risks and opportunities of climate change'*, respondents identified short-termism as a key barrier to the integration of climate risk into investment decision-making. One fund manager said:

*"the most significant barrier is the imbalance between the relatively short term horizons of mainstream investment analysis and the relatively long term nature of the material business impacts of climate change."*³

To be clear, this is not about holding periods, but about the timescales over which investment performance and risk are assessed.

There is clearly some dispute over whether available data suggests a decline in holding periods

¹ Johnson & De Graaf, 'Modernising Pension Fund Legal Standards for the 21st Century', Rotman International Journal of Pensions Management, Spring 2009, Vol 2, Issue 1

² Hesse, 2008, 'Long-term and sustainable pension investments: A study of leading European pension funds'. See <http://bit.ly/uaPQdd>

³ Hendersons Global Investors. FairPensions, 2009, 'Preparing for the Storm: UK fund managers and the risks and opportunities of climate change', p8. See http://www.fairpensions.org.uk/sites/default/files/uploaded_files/PreparingStorm2009.pdf

among long-only investors. However, we note that some equity funds are being marketed to UK pension schemes with turnover levels upwards of 300%.⁴ It is difficult to see what benefit this brings to beneficiaries with long-term investment horizons. Indeed, studies have shown that higher turnover is associated with correspondingly higher transaction costs which can significantly reduce returns to the ultimate investor.⁵ The Pensions Regulator has also highlighted the potentially negative impact of high turnover as a key factor for trustees to understand in controlling scheme costs.⁶ (See also our response to question 7b in this regard.)

2. How to ensure that shareholders and their agents give sufficient emphasis to the underlying competitive strengths of the individual companies in which they invest.

- a) *How equity analysts and asset managers assess the competitive advantages of companies*
- b) *The extent to which trading on equity markets is guided by analysis of underlying corporate performance, and the extent to which it is driven by analysis of short-term market trends.*

In our view, equity markets are insufficiently guided by analysis of underlying fundamentals, and tend to unduly privilege corporate strategies which maximise short-term profit at the cost of storing up long-term business risks. Our own experience in this regard relates primarily to underlying corporate performance on environmental, social and governance (ESG) factors which may not be reflected in the current share price but could impact upon shareholder value in the long-term.

As noted above, our own survey evidence from UK asset managers suggests that some of these underlying fundamentals are not being fully integrated into investment decision-making because their impacts stretch beyond the horizons of mainstream investment analysis. This is borne out by our experience of engaging investors on ESG issues. For example, in 2010 we co-ordinated shareholder resolutions asking for improved disclosure on the risks associated with BP and Shell's Canadian oil sands projects. Some investors responded positively and the resolution process did prompt significant engagement on the issue.⁷ However, in many cases it proved difficult to interest investors in issues of forward-looking risk management when the company's current performance in terms of share price was strong.

The Gulf of Mexico oil spill provides another illuminating case study in this respect. Indeed, many of the issues exposed by that disaster – for example, poor oversight of third parties – were also those raised by the oil sands resolutions, debated at BP's AGM just a few weeks before the spill. The recently-published account of the spill by Tom Bergin⁸ – an oil analyst and journalist with strong inside access to BP – alleges that it was not an unforeseeable disaster but the result of a flawed incentive structure which “encouraged managers to put short-term financial goals ahead of the long-term health of the business and its employees”. Individual managers were incentivised to cut costs and neglect essential maintenance and safety measures, knowing they would be moved on before the consequences of this neglect were realised. A small minority of investors (generally SRI

⁴ For example, Absolute Insight UK Equity Market Neutral Fund – Simplified Prospectus issued 10 January 2011 shows portfolio turnover rate for accounting period ending 30/04/10 was 371.46% (page 7).

⁵ See for example Frontier Investment Management LLP Research, 2007, ‘When is a total expense ratio not a total expense ratio’, p3, <http://www.frontierim.com/uploads/frontierinvestmentmanagement-whenisaternotater.pdf>; Woolley P., 2010, 'Why are financial markets so inefficient & exploitative; and a suggested remedy', in LSE, 'The Future of Finance', p134 (online), p119 (hard copy)

⁶ TPR, 2011, ‘Enabling good member outcomes in work-based pension provision,’ p20 and p36, <http://www.thepensionsregulator.gov.uk/docs/dc-discussion-paper-2011.pdf>

⁷ See IMA, 2010, 'Adherence to the FRC's Stewardship Code At 30 September 2010', p22, <http://www.investmentuk.org/research/stewardship-survey>

⁸ Bergin, T. 2011, 'Spills and spin: the inside story of BP', Random House. See also review by FairPensions at <http://www.fairpensions.org.uk/blog/201108/review-%E2%80%93-spills-and-spin-inside-story-bp-0>.

funds) chose not to hold BP at this time, precisely because of concerns over safety risks. Yet these concerns were largely ignored by mainstream investment analyses. Bergin suggests that investors had little interest in examining or questioning BP's strategy, since it was successful in improving short-term profitability: analysts did not probe too deeply into company claims that safety was improving, for which Bergin argues there was little evidence. Indeed, analysts were still issuing 'buy' recommendations as the crisis unfolded, insisting the company was fundamentally sound. In other words, most investors failed to value the underlying risks inherent in BP's strategy, which at the peak of the ensuing crisis led the company to lose two-thirds of its market value and cancel its dividend for the first time since World War II.

3. Whether the current functioning of equity markets gives sufficient encouragement to boards to focus on the long term development of their business.

- a) *whether changes in reporting obligations have influenced the perspectives and timescales of managers and boards, and whether these changes in perspectives and timescales help or hinder long-term decision making.*

Numerous papers have made links between the increasing frequency of reporting and short-termist decision-making by both companies and investors – for example, Haldane's *'Patience and Finance'*,⁹ and, in a US context, Graham's *'The Economic Implications of Corporate Financial Reporting'* (a survey report which concluded that “managers are willing to sacrifice economic value to manage financial reporting perceptions”¹⁰). However, evidence does not support the idea that regulatory requirements are solely to blame. Rather, it suggests a more complex interplay of both mandatory and voluntary reporting with investors seeking short-term return and managers anticipating investor demands. See for example Graham et al's discussion of voluntary disclosures, which notes that “CFOs point out that mandated summary financial statements are reported once a quarter and, hence, lack timeliness.”¹¹

In the current climate, even if regulatory requirements for quarterly reports were withdrawn or amended (as is currently being proposed by the European Commission)¹², it seems likely that many firms would continue to provide them in response to investor demand. Indeed, this dynamic has been noted in relation to quarterly earnings guidance in the US.¹³ A focus on reporting obligations in and of themselves could become something of a red herring unless underlying agency and incentive problems in the investment chain are tackled as well.

We would also be concerned about any backlash against reporting in general which might carry the danger of reducing accountability. For example, regular reporting by investors themselves on engagement and voting would not seem likely to exacerbate short-termism. On the contrary, it could help to promote more meaningful stewardship by increasing accountability to ultimate beneficiaries.

- c) *Whether publicly traded companies pay too much attention (or feel obliged to pay too much attention) to short-term fluctuations in their share prices.*

Graham et al (2005) provide some useful evidence in this regard, albeit in a US context. Of 401

⁹ Haldane A., 2010, 'Patience and Finance', p12, <http://www.bankofengland.co.uk/publications/speeches/2010/speech445.pdf>

¹⁰ Graham et al, 2005, 'The Economic Implications of Corporate Financial Reporting', http://papers.ssrn.com/sol3/papers.cfm?abstract_id=491627

¹¹ Graham et al, 2005, op cit, p31

¹² Draft Transparency Directive, http://ec.europa.eu/internal_market/securities/docs/transparency/modifying-proposal/20111025-provisional-proposal_en.pdf

¹³ See for example <http://www.ft.com/cms/s/0/e278987a-6ba8-11db-bb4a-0000779e2340.html#axzz1dOAl07vE>, <http://www.ft.com/cms/s/0/012216b8-b7b6-11da-b4c2-0000779e2340.html>

financial executives interviewed, 78% said they would give up long-term economic value to maintain smooth earnings flows to their investors in the short term. 55% said that they would avoid initiating a very positive Net Present Value project if it meant falling short of their earnings targets for the current quarter. In turn, the study found that “managers are interested in meeting or beating earnings benchmarks primarily to influence stock prices.”¹⁴ In another study, Asker et al found that publicly held companies are investing at around half the rate of privately held companies, and suggested that this is because the returns from such investment will not be realised on a quarterly basis.¹⁵

There is evidence that this mentality also holds sway among UK publicly traded companies. For example, in a recent study for ACCA:

*“Interviewees were asked whether directors’ duties amounted to a duty to maximise shareholder value, and broadly speaking this was agreed. While there were differing views over whether this meant maximising share price in the short term, interviewees from the corporate sector thought that this was exactly what it meant.”*¹⁶

The Commission on Ownership has argued, based on its consultations with company directors, that the market for corporate control is the ultimate driver of management decision-making and that this can be traced to features of the UK corporate governance regime which are not replicated in other major economies. The Commission's Chair, Will Hutton, has claimed that

*“British companies think, strategise, innovate and invest their way to success far less than their competitors in different ownership regimes. They know the penalty for one wrong move is to be taken over.”*¹⁷

4. Whether Government policies directly relevant to individual quoted companies (such as regulation and procurement) sufficiently encourage boards to focus on the long term development of their business.

b) whether government policies aimed at facilitating long-term investment by companies have been effective and whether there are other ways government could support long-term business growth.

Section 172 of the Companies Act 2006, which sets out directors' duties, was intended in part to facilitate long-term investment by clarifying that directors were not obliged by law to focus narrowly on short-term financial performance but were free to take a more 'enlightened', long-termist approach. However, it appears to have been less successful in this respect than many people hoped: a recent ACCA study, referred to in response to Q3c) above, found that section 172 has had little impact either on directors' behaviour or on the way they regard their legal obligations.¹⁸ This seems to be particularly the case in hostile takeover situations, where directors presume that their legal duty reverts to the 'underlying' necessity to maximise the share price, rendering section 172 irrelevant. This is evidenced by the anecdotal evidence of key players in the Cadbury-Kraft takeover.

We would suggest that one reason for this is the Act's failure to take a holistic approach which

¹⁴ Graham et al 2005, op cit, p2

¹⁵ Asker, Farre-Mensa, and Ljungqvist, *Does the Stock Market Distort Investment Incentives?*, (<https://files.nyu.edu/jfm359/public>, 2011)

¹⁶ Collison et al, 2011, 'Shareholder Primacy in UK Corporate Law: An Exploration of the Rationale and Evidence', Certified Accountants Educational Trust; p6. See http://www.acca.co.uk/pubs/general/activities/research/research_archive/rr-125-001.pdf

¹⁷ <http://ownershipcomm.org/news/2010/12/29/will-hutton-we-have-the-oddest-and-most-regressive-constitution/>

¹⁸ Collison et al, 2011, op cit, see, for example pp 6 & 39

addressed both company directors and company owners. Put simply, the Companies Act's ethos of 'enlightened shareholder value' relies on the presence of enlightened shareholders. The basic duty of company directors is to promote the success of the company in the interests of its shareholders. When asked, directors are clear that, if what shareholders want is to maximise the share price in the short term, this trumps the Act's provision that directors should 'have regard' to long-term and wider factors in their decision-making.

If shareholders interpret their own duty to their beneficiaries as the maximisation of short-term return, it is hardly surprising that this imperative will be transmitted up the chain to directors. At present, as detailed in FairPensions' recent report '*Protecting our Best Interests: Rediscovering Fiduciary Obligation*',¹⁹ that is exactly how most institutional investors appear to regard their legal duties.

The problem of unduly narrow and short-termist interpretations of investors' fiduciary duties precisely parallels the problem with interpretations of directors' duties which section 172 was designed to solve. It is our belief that these two problems can only ever be solved together, and that there is therefore a need to revisit section 172 and consider a parallel provision for institutional investors themselves. We elaborate on this in response to Question 6.

5. Whether Government policies directly relevant to institutional shareholders and fund managers promote long-term time horizons and effective collective engagement.

- a) *whether pension regulation, insurance regulation, supervision of charitable endowments and regulatory requirements for asset managers lead to excessive emphasis on benchmarking and on short-term performance measurement*
- b) *whether the broader regulation of equity markets has an impact on the investment timescales of market participants*
- c) *whether the regulation of contact between companies and investors is an obstacle to effective engagement.*

We are aware that many stakeholders have pointed to accounting rules as a driver of short-termism, a position for which there does appear to be some evidence. Triennial valuations based on mark-to-market accounting clearly loom large in the minds of trustees of defined benefit schemes, and create a perverse incentive to boost the short-term value of assets in the run-up to a valuation. It was even suggested to us by one industry insider that the reluctance of some pension funds to support 2010's shareholder resolutions on oil sands was rooted in the fact that they were facing triennial valuations and did not wish to negatively impact the share price of the companies concerned.

We are also aware of concerns that concert party rules may hamper effective collective engagement. Our own experience suggests that these concerns are genuine, as we have heard anecdotally even from very committed, engaged investors that they are wary of collective engagement for this reason. However, successful collective engagement does take place under the current regime – for example through the UNPRI Clearing House. Indeed, FairPensions often co-ordinates collective engagement on particular issues, for example through joint investor letters to CEOs or shareholder resolutions. We are sceptical of the implication that a great mass of investors is eager to engage if only this regulatory barrier were removed. In our experience, there is often a cultural unwillingness to participate in collective engagement, particularly where this may have a public dimension, and many investors are reluctant to robustly challenge company boards in all but the most extreme circumstances.

¹⁹ FairPensions, 2011, '*Protecting our Best Interests: Rediscovering Fiduciary Obligation*', available online at <http://www.fairpensions.org.uk/fiduciaryduty>

Overall, although there are clearly respects in which the regulatory environment could be improved, our experience does not suggest that regulatory barriers are the primary driver of short-termism. For example, ‘emphasis on benchmarking and on short-term performance measurement’ can be attributed to a complex range of factors, including asset owner desire to hold agents to account, as well as the perception that fulfilment of asset owners’ fiduciary duties depends on following industry practice rather than exercising independent judgement. We would therefore not expect that amending unhelpful regulations would cause a sea-change in investor behaviour unless underlying cultural, behavioural and agency issues are tackled.

6. Whether the current legal duties and responsibilities of asset owners and fund managers, and the fee and pay structures in the investment chain, are consistent with these long-term objectives.

We would like to comment on the legal duties and responsibilities of asset owners and managers, having recently completed a significant piece of research on this issue.²⁰ We have concluded that investors’ fiduciary duties, as currently interpreted, are acting as a driver of short-termism when they should do the opposite.

Pension fund trustees have a fiduciary duty to act in the best interests of their beneficiaries. It is our view (see response to c) and d) below) that these common law duties also apply to others with discretion over the management of another’s assets, such as fund managers. The two core fiduciary duties of investors are:

- a) Loyalty (to act in the best interests of beneficiaries, and, in case of a conflict, in their sole interest; this is designed to prevent fiduciaries from abusing their position for their own ends)
- b) Prudence (to take such care as an ordinary prudent man would take if investing for the benefit of other people for whom he felt morally bound to provide;²¹ this encompasses duties to seek proper advice, to maintain a diversified portfolio, and to take all relevant considerations into account).

However, these duties – particularly the duty of loyalty, and its associated requirement to avoid conflicts of interest – appear to be poorly understood by the investment industry. Instead, both loyalty and prudence have been distorted into the mantra of a single, monolithic “fiduciary duty to maximise returns”. This interpretation is in part attributable to a particular reading of the 1984 case of *Cowan v Scargill*, in which the judge stated that investment powers must normally be exercised “so as to yield the best return for the beneficiaries, judged in relation to the risks of the investments in question”.²² This is generally interpreted narrowly as referring to short-term returns: both in our direct engagements with investors and in our supporters’ attempts to engage their pension funds, fiduciary duty is frequently invoked to justify a failure to engage with investee companies, particularly on a long-term environmental or social risk. For example, one supporter who contacted their fund to ask how it intended to vote on 2010’s shareholder resolutions on oil sands was told that the fund’s managers “[would] have to balance the environmental issues against their legally over-riding fiduciary responsibilities to produce the highest risk-adjusted returns for

²⁰ FairPensions, 2011, ‘Protecting our Best Interests: Rediscovering Fiduciary Obligation’, available online at www.fairpensions.org.uk/fiduciaryduty

²¹ *Re Whiteley* [1886] LR 33 Ch D 347

²² The case of *Cowan v Scargill* concerned a dispute between union- and employer-nominated trustees in the mineworkers’ pension scheme. The union-appointed trustees, led by Arthur Scargill, refused to approve the fund’s investment policy unless it excluded all overseas investments and all investments in sectors competing with coal (ie. oil and gas). The judge ruled in favour of the employer-nominated trustees that this was a breach of fiduciary duty. Although the circumstances of the case bear little relation to modern debates about responsible investment, the case continues to cast a long shadow over trustees’ investment decisions, perhaps because of the paucity of case law or other legal authority in this area. For a more in-depth analysis of the judgement in *Cowan v Scargill*, see pages 79-81 and 90-91 of our report, ‘*Protecting our Best Interests: Rediscovering Fiduciary Obligation*’.

the Fund”. This was despite the fact that the resolutions were business-focussed, requesting additional disclosures on the companies’ management of financial risks associated with the projects.

There are two issues here: the interpretation of 'best return' and the interpretation of the underlying legal duty. In relation to securing the 'best return', DC pension investing remains largely focussed on beating the index on a quarterly and annualised basis, while even the more sophisticated liability-driven DB pension funds focus intensively on short-term fluctuations in asset prices. Yet 'best return' could instead be considered in the context of the beneficiaries' long-term investment horizons and the likelihood that strong and stable companies in a strong and stable economy will deliver the best outcomes for them over this timescale. Similarly, in 2005, a landmark report by law firm Freshfields Bruckhaus Derringer²³ concluded that there was significant evidence that environmental, social and governance issues could have an impact on returns, and that it was therefore part of investors' fiduciary duties to give them appropriate consideration. This report, and resulting initiatives such as the UN Principles for Responsible Investment, have had some effect on thinking in the pensions and investment industry, particularly among the largest and best-resourced investors. Nonetheless, widespread misconceptions about the scope of fiduciary duty remain a barrier to the consideration of issues which clearly are material to long-term company success.

But the problem lies not just in a narrow interpretation of 'best return' but in a narrow interpretation of fiduciary duty itself, which excludes any consideration of beneficiaries' broader interests. For example, an investment officer at one multi-employer pension scheme recalls seeking legal advice on whether, in the event of a hostile takeover bid, the trustees could consider the fact that a substantial number of their beneficiaries would lose their jobs if the takeover went ahead. Their lawyers advised that this was not a relevant consideration: trustees could only consider the share price. In other words, an asset owner who wanted to take an 'enlightened' approach to the merits of a takeover bid was told that the law prohibited them from doing so. This helps to explain the experience of directors, for example during the Cadbury-Kraft takeover bid, who report coming under explicit legal pressure from shareholders to get the best price for their shares and discard all other considerations.

Similarly, beneficiaries are often baffled when their funds tell them that their concerns about climate change cannot be taken into account because of the fund's legal duty to act in their best interests. Leaving aside the argument that climate change presents a long-term financial risk, pension pots do not exist in a vacuum, but with the ultimate purpose of allowing beneficiaries to enjoy a decent standard of living in retirement. Faced with a choice between a strategy which maximises return in the short-term, but ultimately delivers lower spending power and a lower quality of life for beneficiaries (for instance, by contributing to irreversible climate change), and a strategy which projects a marginally lower return but which contributes to a sustainable economic future for retirees, should trustees really feel legally obliged to choose the former?²⁴

A separate problem is what US academic Keith Johnson calls the “lemming standard”.²⁵ The duty of prudence has historically been interpreted in relative terms, by reference to the behaviour of

²³ UNEP-FI, 2005, 'A legal framework for the integration of environmental, social and governance issues into institutional investment'

²⁴ There is of course a collective action problem in this context, since a fiduciary investor acting alone will likely not be able to have any measurable effect on generic environmental or macro-economic problems that may adversely affect its beneficiaries, whereas a critical mass of institutional investors may well possess that power. *Protecting our Best Interests* suggests various ways to help overcome this problem without diluting the fiduciaries' exclusive duty of loyalty to their beneficiaries.

²⁵ Johnson and de Graaf, 'Modernising Pension Fund Legal Standards for the 21st Century', *Rotman International Journal of Pensions Management*, Spring 2009, Vol 2, Issue 1 ; Johnson, K. 2010, 'Back to the Future of Pension Fund Trust Fiduciary Duties' (available online at www.fairpensions.org.uk/sites/default/files/uploaded_files/KeithJohnsonFiduciaryDuty.pdf)

other 'prudent' investors. This means that trustees feel obliged to follow conventional investment strategies, usually in the guise of recommendations made by their advisors. Such a standard may have been appropriate in the nineteenth century, when much of the relevant case law was laid down, but it is clearly not appropriate to our growing understanding of the systemic risks posed by markets with a tendency to herd. When, as now, conventional approaches are based on short-term, benchmark-relative returns, 'prudent' investment becomes not the strategy which best accords with beneficiaries' long-term interests, but potentially the reverse.

Clearly, some of the issues surrounding interpretations of fiduciary duty are cultural, and they are also intertwined with current incentive structures and investment orthodoxies. However, we conclude that there is nonetheless a fundamental problem with interpretation of the law, and that this is unlikely to be resolved without clarification of the law. On this basis, we suggest statutory clarification for institutional investors designed to complement section 172 of the Companies Act's provisions for directors (see response to Q4).

b) How individual asset managers are rewarded, and their performance measured, and whether this gives insufficient incentive for them to take a long term view of the companies in which they invest

We cannot comment on remuneration structures as they apply to individual managers within asset management firms. However, it does seem clear that the way in which asset managers are incentivised by their pension fund clients contributes to short-term outlooks. If a strategy which might be prudent in the long-term carries a risk of short-term under-performance relative to the benchmark, managers may miss targets, forfeit bonuses, and ultimately even lose mandates. In one European study, pension funds themselves blamed short-term, benchmark-relative remuneration structures for the fact that their investment horizons were much shorter than would be ideal (see response to Q1). This suggests that asset owners are aware that incentive problems exist but are struggling to find solutions. Initiatives such as the International Corporate Governance Network (ICGN)'s Model Mandate Initiative,²⁶ which are attempting to develop practical ways for pension funds to align their managers' incentives with the long-term interests of their beneficiaries, are worth exploring.

c) Whether there are agency problems in the objectives and operations of asset managers that may be deleterious to the interests of the corporate sector or savers

d) How other intermediaries and market participants are remunerated and what impact this has on their incentives and those of their clients.

As Paul Woolley has argued,²⁷ failure to recognise agency problems is one of the key reasons why capital markets do not behave as economic theory predicts. But in a pensions context, the problem is even more complex. Discussions about the investment chain often fail to recognise the 'double agency' problem, whereby asset managers act as agents for asset owners who are themselves agents for the ultimate beneficiaries. Instead, analysis often proceeds as if asset owners were the principals and the relationship between asset owners and asset manager the only one that matters. Meanwhile, savers remain disconnected from decisions about their money, and the fiduciary framework designed to protect them is becoming increasingly dysfunctional.

Asset owners themselves often lack expertise, leaving them vulnerable in relation to their commercial agents. Asymmetric information creates opportunities for rent extraction by various parties within the investment chain, for example through excessive complexity. It is worth noting that this problem applies to investment consultants as well as asset managers. There is evidence

²⁶ See www.icgn.org/files/icgn_main/pdfs/agm_reports/2011/item_9.2_icgn_model_mandate_initiative.pdf and www.icgn.org/files/icgn_main/.../mmi_consultation_31jan2011.pdf

²⁷ Woolley, 2010, op cit

that pension schemes' investment approaches have become significantly more complex in recent years – for example, the average externally managed pension scheme has nine mandates, compared to just three a decade ago.²⁸ This trend has cost pension funds up to a third extra in management fees, and has also increased the fees paid to consultants due to the higher number of manager selection processes.²⁹ It is questionable whether this increased complexity has been value for money in terms of improved performance.

Many within the industry acknowledge this problem: for example, Douglas Ferrans, Chairman of the IMA, has said that his industry has too often “*unwittingly placed their own interests ahead of those of their clients*”, and that they must do more to “*challeng[e] the excessive intermediation that is creeping into the system... [which] often manifests itself in conflicts of interest which clearly act against our customers' interests.*”³⁰ However, elsewhere there is a concerning complacency about this danger: Richard Saunders, Chief Executive of the IMA, recently dismissed Paul Woolley's work by complaining that he

*“fail[s] to distinguish between those (like investment banks) who operate as principals and can profit at the expense of clients and those (like investment managers) who act as agents, where interests are aligned with investors. This simple point blows his whole argument out of the water when it comes to investment managers.”*³¹

This argument assumes away the very question at issue: are the interests of investment agents effectively aligned with those of their principals? Evidence suggests that they are not. A recent report by Lane Clark & Peacock found that even performance-related fee bases were “skewed in the managers' favour”, doing little in practice to align managers' interests with those of trustees and beneficiaries.³²

Fiduciary duties exist precisely to deal with situations where asymmetric knowledge and power make principals vulnerable in relation to their agents. It is widely accepted by legal experts – including the Law Commission³³ – that, for this reason, investment managers are fiduciaries under common law. Yet this does not appear to be widely accepted within the asset management industry. Many asset managers describe themselves as fiduciaries, but, when pressed, they generally define this in terms of a general duty of care to clients (such as already exists under FSA rules), and are reluctant to accept that they are fiduciaries in the strict legal sense.³⁴

This matters because fiduciary duties impose much stricter rules than FSA regulations about, for example, the management of conflicts of interest. Indeed, the prime fiduciary duty is to try to avoid such conflicts altogether.³⁵ Financial services conglomerates often have business relationships with investee companies which are commercially more significant than the stakes held by their asset management arms. Asset managers themselves may be seeking business from their investee companies' own pension schemes. These conflicts may unduly influence asset managers' decisions, or discourage them from speaking out about poor corporate governance.³⁶ In a US context, some empirical and theoretical studies have suggested that existing or potential business relationships with investee companies do influence the voting decisions of large mutual funds.³⁷ In the UK, our

²⁸ The WM Company, 2010, cited in Lane Clark & Peacock, 2011, Investment Management Fees Survey, p13.

²⁹ Ibid, p14

³⁰ Douglas Ferrans, Wednesday 9 June 2010, Speech to IMA Annual Dinner

³¹ <http://www.investmentfunds.org.uk/commentary/06-06-2011>

³² Lane Clark & Peacock, 2011, 'LCP Investment Management Fees Survey'

³³ Law Commission, 1992, 'Consultation Paper No. 124: Fiduciary Duties and Regulatory Rules' (HMSO)

³⁴ See for example page 38 of 'Protecting our Best Interests'

³⁵ See FairPensions, 'Protecting our Best Interests', p32-36

³⁶ See for example Wong, Nov 2011, 'How Conflicts of Interest Thwart Institutional Investor Stewardship',

<http://blogs.law.harvard.edu/corpgov/2011/11/06/how-conflicts-of-interest-thwart-institutional-investor-stewardship/>

³⁷ See for example Davis & Kim 2007, Matvos & Ostrovsky 2010, cited in Dasgupta and Zachariadis, 2011, 'Delegated Activism and Disclosure', page 6, available at

research suggests that inattention to fiduciary duties in principle is matched by inattention to conflicts of interest in practice. In our recent survey of asset managers' disclosures under the Stewardship Code, conflicts of interest policies were one of the weakest areas (see response to Q8 for full details).

As indicated in *Protecting our Best Interests*, we believe that where the avoidance of conflicts of interest is deemed incompatible with current business models, government and regulators should be willing to countenance the possibility that it is the business models and not the fiduciary duties which must be changed. This could entail regulatory changes to the range of services permitted within a single entity, requiring disaggregation of some financial conglomerates.

7. Whether there is sufficient transparency in the activities of fund managers, clients and their advisors, and companies themselves, and in the relationships between them.

a) whether the existing rules on disclosure of material stakes are excessive or inadequate;

The answer to this question depends on who disclosures are thought to be for: companies, end-beneficiaries, other investors, etc. From the perspective of end-beneficiaries, we believe that the current disclosure regime around company ownership may be inadequate. It is generally impossible to identify the beneficial owners of shares, 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. Generally the only response we can give is that, if the company is in the FTSE 100, it is likely to be held by their fund, although this does not give them any idea of the size of their fund's stake or the company's importance to their overall portfolio.

If part of the purpose of transparency is to foster an effectively functioning market by empowering consumers to transmit their demands up the investment chain, there is a case for examining this aspect of the disclosure regime. Thought would need to be given as to the appropriate mechanism for enhancing disclosures to end-beneficiaries: there does not seem any obvious reason why this should fall to the company through its disclosure of material stakes. Indeed, beneficiaries are likely to be more interested in the significance of their fund's stake to their own portfolio than its significance to the firm. Rather it may be a question of the information provided further along the investment chain, i.e. by asset managers to their clients and/or by pension funds to their beneficiaries.

b) whether asset managers should be subject to more extensive disclosure requirements, e.g. of costs and remuneration structures;

It is increasingly clear that currently available figures do not necessarily provide a full picture of total asset management costs. The Pensions Regulator recently summarised the situation as follows:

“Annual Management Charges (AMCs) are often relatively simple to access. But they do not contain all relevant charges. Total expense ratios (TERs) were developed to be more comprehensive but TERs do not include initial charges. The ‘Reduction in Yield’ measure includes initial charges. None of these measures include the impact of portfolio turnover where higher turnover will lead to higher transactions costs.”³⁸

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1652148

³⁸ TPR, 2011, ‘Enabling good member outcomes in work-based pension provision, p20. Available at <http://www.thepensionsregulator.gov.uk/docs/dc-discussion-paper-2011.pdf>

TPR concludes that “it is important to have figures on all charges to understand the full impact”, but this does not always seem to be possible. Anecdotally we have heard from trustees of several different schemes that they have tried to access information on portfolio turnover and associated costs from their asset managers, and have been unable to do so. It is difficult to see how a functioning market is possible under such circumstances. There is therefore a strong case for revisiting disclosure requirements to ensure that comprehensive and understandable information about costs is provided.

In addition to costs, we would urge the Review to consider the evidence on voting disclosure, which was consulted on as part of the government’s original call for evidence, *A Long-term Focus for Corporate Britain*. As we argued in response to that consultation,³⁹ there are clear benefits to public disclosure of investors’ voting records:

- ⤴ Promotion of competition and of more effectively functioning markets, by allowing prospective as well as existing clients to scrutinise and compare managers’ records;
- ⤴ Accountability to ultimate asset owners, such as pension fund members, who may find it difficult to access information if it is provided only to institutional clients;
- ⤴ More considered use of voting rights; and
- ⤴ Protection of the public interest in transparency regarding major investors’ voting decisions. As Sir David Walker noted in his post-financial crisis review, “*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.*”⁴⁰

Under section 1277 of the Companies Act 2006, the government has reserve powers to introduce mandatory voting disclosure for institutional investors. Evidence suggests that voluntary initiatives to promote transparency in this area are making slow progress. The Stewardship Code has been partially successful in encouraging voting disclosure, which is incorporated into Principle 6 of the Code.⁴¹ However, when the IMA surveyed signatories to the Code in September 2010, only two-thirds of respondents disclosed their voting records, and, of these, only two-thirds disclosed information about individual resolutions as opposed to summary statistics. Of those who chose to ‘explain’ rather than ‘comply’ with this principle, the vast majority did not express an intention to begin disclosing in the future. Our own research supports this picture: among respondents to our 2010 survey of asset managers, the quality of voting disclosure varied widely with only isolated examples of what we would regard as full disclosure.⁴² This suggests that, even among investors who commit to the Stewardship Code, voting disclosure remains extremely patchy.

A similar picture emerges for asset owners. According to figures from the National Association of Pension Funds (NAPF), from 2008-2010 the proportion of pension funds disclosing voting information to their beneficiaries stagnated at around 24% - with even fewer disclosing this information publicly.⁴³ This corresponds to our practical experience: at present, individual pension fund members are often unable to access information about voting intentions or voting decisions even when they specifically request it. This was the experience of many of our supporters who contacted their pension providers about last year’s oil sands resolutions at BP and Royal Dutch Shell.

³⁹ Available online at http://www.fairpensions.org.uk/sites/default/files/uploaded_files/LongTermismResponse01-11.pdf, see pages 7-8

⁴⁰ Sir David Walker, 26 Nov 2009, *Final Recommendations*, p12.

⁴¹ FRC, The UK Stewardship Code, available at <http://www.frc.org.uk>

⁴² For full details, see FairPensions, 2010, ‘Stewardship in the Spotlight’, available online at http://www.fairpensions.org.uk/sites/default/files/uploaded_files/whatwedo/StewardshipintheSpotlightReport.pdf.

⁴³ National Association of Pension Funds, ‘Pension funds’ engagement with companies’ 2008 and 2010. Available online at <http://www.napf.org.uk>.

This is important because beneficiaries, as the ultimate consumers, are a potentially powerful force which could drive demand for long-termism and better stewardship up the investment chain. Many beneficiaries would prefer their funds to take a more long-term approach to a host of voting decisions, be it on hostile takeovers, executive remuneration or sustainability. Yet when individuals savers try to create such consumer demand by asking questions about their funds' stewardship practices, they are frequently rebuffed. (Some examples of this are given in Appendix 1.) Creating a culture of transparency and accountability about the exercise of ownership rights is vital. Given the slow progress in this area, we would favour the use of the government's reserve powers to introduce mandatory voting disclosure.

c) whether the growth of investment consultants has encouraged or discouraged engagement by share owners with companies;

In general, the growth in trustee delegation has led to a lack of clarity in the respective responsibilities of asset owners, asset managers and consultants. Pension fund trustees are under a statutory duty to obtain and consider the written advice of investment consultants when preparing or revising their Statement of Investment Principles (which will include any policy on voting).⁴⁴ Their duty of prudence will also normally require them to take advice in connection with key decisions such as the selection of asset managers. Yet the fiduciary obligation to serve beneficiaries' interests remains firmly with the trustee: the courts are clear that they cannot simply 'outsource' their judgement to advisors.⁴⁵

Our experience of the practical consequences of this situation relates largely to integration of ESG issues, but we believe that the same issues apply to engagement in general. Evidence suggests that actors at each stage of the investment chain see ESG integration as 'somebody else's problem'. In our 2009 survey of asset managers, one of the biggest reasons cited for lack of integration of climate change was lack of client demand.⁴⁶ Yet when ACCA surveyed trustees about the same issue in 2009, they argued that it was their managers' responsibility to integrate material issues into their analysis, with one trustee even saying, "*It's not our place as trustees to dictate to a manager.*" ACCA concluded that "*[trustees'] decision to delegate investment decisions to their fund managers has led to an impression that this frees them from a need to consider potentially material risk factors.*"⁴⁷ In the same way, there is some evidence that asset managers look to asset owners to give them a mandate to engage with companies, while asset owners assume that managers will do this as standard if it contributes to long-term returns.

Consultants are potentially in a good position to break this impasse. But there is some evidence that they too view client demand as the main driver for providing advice on ESG issues,⁴⁸ with many viewing their role as "secondary or reactive."⁴⁹ With the advent of the Stewardship Code this may no longer be true of engagement in general: indeed there is some anecdotal evidence that consultants are actively encouraging their clients to consider their approach to stewardship and engagement. However, in our experience such activities can be concentrated in consultants' RI and governance teams, and may not translate throughout the business into individual consultants' interactions with their clients.

The FRC recognises the need for the Stewardship Code to be more differentiated in order to provide clarity about the role of asset owners in engagement. This will be important to address the potential vacuum of responsibility created by increased delegation. Consideration should also be

⁴⁴ The Occupational Pension Schemes (Investment) Regulations 2005, SI 2005/3378, regulation 2(2)

⁴⁵ See for example *Martin v City of Edinburgh District Council*, 1988 SLT 329, 1988 SCLR 90

⁴⁶ FairPensions, 2009, 'Preparing for the Storm'

⁴⁷ Solomon, 2009, 'Pension Fund Trustees and Climate Change', (ACCA), p24

⁴⁸ Eurosif, 2009, 'Investment Consultants and Responsible Investment Study', p13

⁴⁹ UNEP-FI, 2009, 'Fiduciary responsibility: legal and practical aspects of integrating environmental, social and governance issues into institutional investment', p36

given as to whether the legal responsibilities of different parties within the investment chain needs to be clarified.

d) whether the overall costs of intermediation are understood by beneficiaries, and are proportionate to the value of the services provided;

It is difficult for the true costs of intermediation to be understood by beneficiaries since they are often complex or counter-intuitive: see for example the RSA's calculation that a 1.5% annual management charge will amount to a total cost of around 40% over the life of a pension.⁵⁰ Behavioural research suggests that, in general, it is unrealistic to expect the ordinary saver to fully understand the risks and costs associated with long-term saving. Again, the disconnectedness of beneficiaries – the ultimate consumers – in all types of private pension provision makes it unlikely that the industry will function as an efficient market, and possible that excessive fees and charges will proliferate.

From 2002-2007, pension funds' payments to intermediaries rose by an estimated 50%,⁵¹ while annual real returns on pension investments averaged just 1.1%, significantly lower than preceding decades.⁵² A recent survey by Lane Clark & Peacock found little correlation between the level of fees charged by managers and the degree to which they outperformed the market. It also found that market performance rather than manager skill was the main driver of fee increases in 2010, such that an equity manager who underperformed the market by 2% could still expect a 20% increase in fees.⁵³

e) whether investors have sufficient information to understand the investment approaches of asset managers and to judge whether they are aligned with their investment objectives and timescales.

As indicated above in response to question a), it appears that asset owners are often unable to access information about portfolio turnover which would be relevant to understanding their managers' investment approaches and the extent to which they align with their investment horizons. As Paul Woolley has argued, it is difficult to see how high-turnover strategies contribute to the investment objectives of long-term investors such as pension funds.⁵⁴ There appears to be an accountability gap in respect of this aspect of investment strategy.

More generally, we would question whether some asset owners are even in a position to ask the right questions to judge their asset managers' approaches. In private, some trustees have suggested that many pension funds' relationships with their asset managers are not so much ones of delegation as of 'abdication'. Taking advice from consultants, funds may simply assume that managers are best placed to align their investment approach with the funds' objectives – in the same way they assume that managers will take all material issues into consideration. The parameters of asset owners' roles are increasingly unclear, with the extent of delegation and of information asymmetries between trustees and asset managers stretching traditional understandings of the fiduciary relationship.

8. The quality of engagement between institutional investors and fund managers and

⁵⁰ David Pitt-Watson, 2009, 'Pensions for the people: addressing the investment crisis in Britain' (RSA)

⁵¹ Watson Wyatt, 2008, 'Defining Moments: The Pensions & Investment Industry of the Future'.

⁵² Woolley, P. 2010: p135 (online), p121 (hard copy). Real returns averaged 4.1% for the whole of the period from 1963-2009

⁵³ Lane Clark & Peacock, 2011, 'LCP Investment Management Fees Survey'

⁵⁴ Paul Woolley, 2010, in LSE, Future of Finance, op cit

UK quoted companies, and the importance attached to such engagement, building on the success of the Stewardship Code.

- a) *whether the measures taken to stimulate engagement by investors with companies have been sufficiently effective;*

The Stewardship Code has been an important step forward in encouraging investors to take engagement seriously. However, despite the overwhelmingly positive picture portrayed by the IMA's 2010 survey on uptake of the Code, significant problems remain. Our concern overall is that too many asset managers are paying 'lip service' to the Code's principles but may not be fully integrating them in practice. Indeed, stewardship appears to be seen by many as an 'add-on', ancillary to their core concern with investee companies' share price and dividend payouts, rather than an integral part of their responsibilities. The reaction to recent suggestions about shareholder representation on nominations committees (on which FairPensions does not have a view) is instructive in this respect. According to the government's recent discussion paper, some investors rejected this suggestion on grounds that it could hamper their ability to 'exit'.⁵⁵ This tallies with our experience that most institutional investors still regard themselves essentially as traders rather than owners.

This attitude is also reflected in 'tick-box' disclosures of how managers are integrating the Code's principles. In 2010 we conducted a survey of asset managers which examined their disclosures under the Stewardship Code.⁵⁶ Particular areas of weakness identified by our research were:

- **Conflicts of interest:** policies disclosed often simply stated that conflicts would be resolved in the interests of the client, without any indication of situations where conflicts might arise or the measures in place to resolve them.
- **Comply-or-explain:** managers' disclosures on their approach to company explanations for non-compliance with the Corporate Governance Code were often platitudinous and offered no insight on the rigour of their approach. This supports the findings of earlier research by the LSE which concluded that "shareholders seem to be indifferent to the quality of explanations."⁵⁷
- **Environmental and social issues:** 17% of managers did not disclose a policy on ESG issues; of those who did disclose, around half focussed on governance with little detail on how environmental and social issues were integrated. However, this was a significant improvement on previous years.

In practice, too, there is still some way to go towards truly robust and effective shareholder engagement. It is still all too rare for institutional shareholders to attend AGMs – with News Corporation's recent AGM in Los Angeles and BP's 2011 AGM providing interesting exceptions. This in itself suggests that engagement may too often be focussed on companies in crisis, rather than on preventing crises from arising in the first place. Investors continue to be reluctant to vote against management, and support for shareholder resolutions is still regarded as a 'nuclear option'. Indeed, there is some evidence that investors are unlikely to scrutinise proxy recommendations unless the proxy voting agency recommends a vote against management (see response to Q9). This perhaps helps to explain the relative ineffectiveness of shareholder votes in holding management to account - for example, the advisory vote on the remuneration report did not see any FTSE 100 reports voted down during the 2011 AGM season, despite the continuing discrepancy between pay and performance.

⁵⁵ BIS, 'Executive remuneration: a discussion paper', page 23; available at <http://www.bis.gov.uk/assets/biscore/business-law/docs/e/11-1287-executive-remuneration-discussion-paper.pdf>

⁵⁶ FairPensions, 2010, 'Stewardship in the Spotlight', available online at http://www.fairpensions.org.uk/sites/default/files/uploaded_files/whatwedo/StewardshipintheSpotlightReport.pdf.

⁵⁷ Arcot, Bruno & Grimaud, 2005, 'Corporate Governance in the UK: Is the comply-or-explain approach working?'

The failure in law and practice to distinguish between a considered abstention and a failure to vote also contributes to high votes in favour of management. When FairPensions co-ordinated shareholder resolutions on oil sands at BP and Shell in 2010, one prominent asset manager told us that they would be voting against, although they supported the substance of the resolution, because they had a policy of not supporting shareholder resolutions, yet would not abstain because they felt it was important to 'use their vote'. This is despite the Stewardship Code's explicit recognition of abstention as a valid voting decision.

Fiduciary duty continues to be regarded as a barrier to engagement by many asset owners. We were recently told by one pension fund trustee that she could not take an interest in how her fund exercised its ownership rights, because she had a fiduciary duty to maximise return, and there was insufficient evidence that engagement and good governance contributed to this objective. Tackling narrow interpretations of fiduciary duty is therefore necessary to promote the success of initiatives like the Stewardship Code, particularly as it attempts to reach out to asset owners.

Moreover, the current narrative around stewardship sometimes treats engagement as a good in itself, assuming that this engagement will promote the long-term success of the company. In fact, the problems highlighted by the financial crisis were as much about destructive engagement as lack of engagement: only one major asset manager (The Co-operative Asset Management) voted against RBS' acquisition of ABN-AMRO, while banks like Lloyds and HSBC came under significant shareholder pressure to adopt less cautious strategies. If the stewardship agenda is to succeed, it must tackle the underlying assumption that the duty of institutional shareholders is to maximise short-term return. Without this, simply promoting engagement will not necessarily lead to good stewardship.

Finally, there is a need to differentiate more between the roles of asset owners, asset managers and consultants (see response to Q7c above), as well as to look beyond the traditional focus on trust-based occupational pension schemes to other major institutional investors, such as insurance companies. The advent of auto-enrolment seems likely to exacerbate the current trend away from trust-based occupational pensions and towards contract-based arrangements, yet the stewardship debate remains firmly focussed on occupational pension funds. We are currently in the process of surveying the leading commercial pension providers on their policies and disclosures regarding engagement and responsible investment. Preliminary findings suggest that these investors have some way to go in recognising their role as asset owners – albeit that, in some cases, their asset management arms take their own stewardship responsibilities seriously. The governance and accountability structures are also less clear, with the possible consequence that demand for stewardship may not be transmitted up the investment chain.

b) whether the corporate governance activities of asset management businesses are sufficiently integrated with the decisions of fund managers.

Anecdotally it appears that engagement activities are not always well aligned with buy/sell decisions and that some corporate governance teams have minimal influence on decisions in other parts of the firm. (See also our response to Q7c in relation to consultants, where a parallel problem may exist.)

Having said this, we would also note that, as long as engagement takes place consistently and effectively and is not directly undermined by decisions elsewhere in the firm, it has value regardless of buy/sell decisions. It is important to overcome the perception that the two are intrinsically linked and that engagement is therefore irrelevant for firms or funds with passive investment strategies. If anything, engagement is all the more important for passive managers, since they do not have the option of exit, making exercise of 'voice' their only means of safeguarding or adding value. The Stewardship Code already states (in Principle 4) that it applies equally to active and passive investors; every opportunity should be taken to emphasise this point.

9. The impact of greater fragmentation and internationalisation of UK share ownership, and other developments in global equity markets, on the quality of engagement between shareholders and quoted companies.

UK pension funds are required by law to maintain a diversified portfolio, “in such a way as to avoid excessive reliance on any particular asset, issuer or group of undertakings and so as to avoid accumulations of risk in the portfolio as a whole”.⁵⁸ In accordance with modern portfolio theory, this has generally been interpreted as an injunction that pension funds should not constrain their investment universe.

It is clear that the average institutional investor with a highly diversified portfolio cannot possibly engage fully with all the companies in their portfolio. This has the potential to create an oversight deficit, particularly in companies which are widely perceived to be ‘well-run’ and which may therefore not be prioritised for investor engagement. Some investors – such as PGGM in the Netherlands – are now taking the view that it is possible to diversify sufficiently whilst operating in a more constrained investment universe which enables full engagement with a limited number of investee companies. Arguably, in line with Warren Buffet’s investment philosophy, the ability of such an investor to acquire an in-depth understanding of (and influence on) the companies they own may counter the dictates of modern portfolio theory that a more concentrated portfolio is necessarily riskier.

Another consequence of diversified ownership is to make reliance on proxy voting agencies inevitable: it is not practicable for managers to scrutinise in detail every single voting decision in every single company they own. The IMA’s recent survey of Stewardship Code signatories stated that “*where [investors] may follow a provider’s recommendation, it is done in a considered way*” – and that, in particular, “*a Manager is likely to take its own view on contentious issues.*”

However, the actual responses cited suggest that this may not in fact be the distinction most managers apply. One asset owner commented: “*our general experience of the industry is that many (if not most) managers robotically follow recommendations.*” One manager is quoted as saying: “*Where the vote recommendation is a vote against, we will review this to ensure it is appropriate*” – implying that the same level of scrutiny might not be applied to a recommendation to vote *with* management on a contentious issue. This is far from being an academic distinction: the most recent AGM season saw numerous examples of contentious votes where conflicting recommendations were given by different proxy voting agencies. One would hope that asset managers would give equal consideration to such issues regardless of whether their own service provider recommended for or against. In practice it is unclear whether voting in such situations is always fully considered.

There is a view that the increase in the proportion of shares in UK listed companies held by international investors must result in less effective engagement. Whilst we recognise the challenges posed by the internationalism of share ownership, we do not share this view. On the contrary, many overseas shareholders are long-term investors, including pension funds and sovereign wealth funds. Furthermore, there are already extensive networks of responsible international investors, such as the UNPRI and the ICGN. We see no reason in principle why these entities should not play a positive role in the governance of UK companies, just as the UK Stewardship Code encourages British companies to apply stewardship principles in relation to foreign investee companies.

Many investors have also raised with us the impact of the ‘internationalisation’ of the index itself: as one asset owner put it, “the UK market is dominated by non-UK domiciled companies

⁵⁸ Occupational Pension Schemes (Investment) Regulations 2005; this requirement is enshrined in European law in the Institutions for Occupational Retirement Provision (IORP) Directive, Article 18

operating in overseas countries with no real stake in the UK economy except their London listing.” This means that investors who track the index, or are benchmarked against it, may be obliged to hold companies with questionable governance (as was highlighted by the recent listing of Glencore), or where it is difficult for them to exert genuine influence over management (as some investors have suggested was the case with Vedanta Resources).

10. Likely trends in international investment and in the international regulatory framework, and their possible long term impact on UK equity markets and UK business.

b) whether recent or planned regulatory actions by authorities outside the UK, and particularly regulatory policy developments at EU level, will affect engagement between asset managers and the companies in which they invest, and the ability of companies to respond to that engagement.

We do not see any reason to believe that current EU proposals on corporate governance pose a threat to effective engagement. Indeed, in increasingly internationalised markets, common approaches to (for example) disclosure requirements and Stewardship Codes could prove more efficient and effective than a proliferation of competing national standards.

In particular, the threat to 'comply-or-explain' posed by current EU proposals has been overstated. The proposal that regulators be authorised to oversee the quality of explanations, rather than simply verifying that a statement has been published, now seems unlikely to be taken forward. However, the backlash against it was somewhat disproportionate. As discussed in question 8, there is evidence that shareholders may not always be rigorous in scrutinising the quality of company explanations. Moreover, it is important to bear in mind that 'comply-or-explain' exists not just for the benefit of the institutional shareholders who are responsible for overseeing it, but ultimately to protect their end-beneficiaries, who often have little or no control over the institution's activities. If institutional shareholders are not fulfilling their responsibilities in this regard, it may therefore be legitimate for regulators to step in.

Ultimately, the effect of proposed EU regulation in this case seems to have been to focus UK minds on the quality of company explanations. We hope that this will eventually lead to better-quality shareholder engagement and a more rigorous approach to holding management to account.

APPENDIX 1: Examples of pension fund responses to member enquiries

Below are three anonymised examples of responses received by FairPensions supporters who emailed their pension fund enquiring about their stance on 2010's shareholder resolutions on oil sands at BP and Shell's AGMs. They illustrate some recurring themes of pension fund responses to member queries about their exercise of ownership rights:

- A tendency to invoke the 'fiduciary duty to maximise returns' as a factor militating against engagement on environmental, social and governance (ESG) issues, even where a clear business case has been made;
- A tendency to state simply that decisions are delegated to fund managers, with no transparency about the manager's voting intentions and no indication that the fund intends to monitor their engagement activity; and
- A tendency to direct members to general documents, such as the Statement of Investment Principles, rather than providing a specific response on the issue at hand.

EXAMPLE 1

Tar Sands Pension Fund Action: E-mail via FairPensions

Dear XXXX,
Thankyou for your email.

We encourage our managers to understand the social, environmental and ethical policies pursued by each company that they invest in on our behalf.

The XXXX Pension Fund delegates it voting decisions to its investment managers and managers are encouraged to exercise these rights. If they vote, then they are expected to vote in the best financial interests of the beneficiaries. Investment Managers will not disclose how they intend to vote before meetings.

I hope this helps.

XXXX
XXXX

EXAMPLE 2

Subject: BP & Shell Tar Sands Resolution

Thank you for your email - I would refer you to our website which contains the following statement:

"Our holdings in BP and Shell (if any) are managed by our global equity manager (XXXX) who employ XXXX a leading research and service provider for responsible investment.

Voting decisions are delegated to XXXX and they are required to take into account environmental issues when deciding how to cast their vote. XXXX take their responsibilities extremely seriously and they will seek appropriate advice before casting votes on behalf of the XXXX Pension Fund. They will, of course, have to balance the environmental issues against their legally over-riding fiduciary responsibilities to produce the highest risk-adjusted returns for the Fund commensurate with the risk budget they have been given so that the Fund can meet its legal obligations to pay pensions as they fall due."

Kind Regards

XXXX

Pension Fund Manager

EXAMPLE 3

Subject: Thank You For Your Enquiry

The XXXX and XXXX Trustees' policies on Corporate Governance and Socially Responsible Investment are set out in the Schemes' Statements of Investment Principles (SIPs) which are available on the member website. The Fund Manager implements the policies and reports to the Trustees with reports to members also being provided on the member website.

This information can be found on : www.xxxx.com

Best Regards

XXXX
