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ShareAction
the movement for **Responsible Investment**

Corporate Governance Reform Team
Department for Business, Energy & Industrial Strategy
By email: corporategovernance@beis.gov.uk

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Dear Sirs

Green Paper on corporate governance reform

We welcome the opportunity to comment on the Government's Green Paper on corporate governance reform. ShareAction is a registered charity working in the investment sector. We strive to build an investment system which encourages businesses to be well-governed and to behave responsibly. We do this in part by working with pension funds, endowed foundations and investment managers to encourage better stewardship of companies. We also empower individual retail shareholders to hold companies to account by raising governance and other concerns (including excessive executive pay) with the boards of public companies at their AGMs.

ShareAction is a member organisation and counts amongst its members well-known NGOs, charitable foundations and over 35,000 individuals. In fact, one such supporter, Barrie Stead, is also submitting a response to this Green Paper in which he sets out commendable proposals drawn from his 20 years of experience as an investor in UK public companies. We fully endorse Mr. Stead's proposals and believe that he has valuable first-hand experience of the barriers facing ordinary shareholders wishing to hold companies accountable.

ShareAction endorses the Prime Minister's vision of an "economy that works for everyone". We agree that one way to achieve this is to address how large companies operate, the impact that they have on society and the economy, and the way in which they are governed. We were pleased to give oral evidence on the issue of corporate governance to the Business, Energy and Industrial Strategy Committee in late 2016.

Before addressing those Green Paper questions on which we can add most value, we will first set out what may be seen as an answer to question 14 (*Is the current corporate governance framework in the UK providing the right combination of high standards and low burdens? Apart from the issues addressed specifically in this Green Paper can you suggest any other improvements to the framework?*). The reason for starting with this question is that we believe that the solutions suggested in the body of the Green Paper, whilst helpful, will not on their own go far enough to create an economy that works for all. We therefore seek to set out some proposals covering closely related issues which we believe must be addressed if the UK is to have a fair economy in which businesses earn the confidence of wider society. We have much experience of working on this area and would welcome the opportunity to expand further on the solutions set out below.

We agree that there is a disconnect between shareholders and companies, such that not all shareholders act as the enlightened stewards needed for effective oversight of companies. This is evident in relation to excessive executive pay, as detailed in the Green Paper. It is also, however, evident in other areas which go to the long-term success of companies. Scandals such as mis-selling, tax avoidance, supply chain issues and exploitation of workers show that governance of companies is failing in other respects also. These failings damage companies' reputations and valuations, and also have negative consequences for employees and customers. These stakeholders are acknowledged in the Green Paper. However, poor corporate governance also has the potential to be detrimental to a wider group of stakeholders: the millions of UK pension savers whose money is invested in large UK companies.

A novel feature of the UK today is that, as a result of pension automatic enrolment, almost every working person has an ownership stake in our economy. Seven million people have become pension savers in the past four years, a figure that will soon rise to ten million and can be added to the sixteen million already participating in a pension plan. Most of these new savers will be saving into "defined contribution" pensions, meaning that the value of their pensions is dependent on the performance of the underlying investments. They therefore have a very real interest in the long-term performance of investments made on their behalf, not least in large public companies.

It is often said that there is an agency problem within the investment system. This has recently been acknowledged by the FCA in its market study of the asset management industry, which highlights that fund managers' interests are often poorly aligned with their clients' interests. There is also an agency problem between ordinary savers and the parties investing their money. If the Government wishes to build a more competitive, sustainable economy where more people share in the gains of economic growth and success, we urge it to look at ways to solve the disconnect between savers and the UK's pensions and investment sector, and ensure that the investment system serves the interests of the ordinary saver. We believe that great gains could be made by addressing two key areas: (1) building a culture of responsible stewardship by institutional shareholders and (2) re-connecting ordinary savers with their money. We will also address the issue of investor duties.

Strengthening stewardship

As the Green Paper notes, there is a need to encourage greater shareholder engagement. However, we believe that this goes further than on the issue of executive pay. If the Government wants to build a fairer economy, it should put in place structures which encourage stronger shareholder engagement on a <u>range</u> of corporate governance issues, not just on executive pay. The UK's system of shareholder primacy gives significant powers to shareholders, who can (and do) engage with companies on a wide range of issues, albeit that they may not have a direct voting veto for many issues other than remuneration. Since institutional shareholders can and do engage with companies on a wide range of issues, it would be a missed opportunity to address only how they do so on executive pay.

Helpfully, the 7 principles of the UK's Stewardship Code itself do not prioritise pay over other issues that investors may wish to engage on. However, since the Code's inception, ShareAction has monitored how it is applied by different actors within the investment sector, and we have repeatedly found that many signatories to the Code take a narrow approach to its application. This may be because it is a relatively "immature" code; it was introduced quickly as a necessary and rapid response to the financial crisis. Since then, it has not been substantially updated or amended. (This is in contrast to its sister code, the Corporate Governance Code). Whilst we welcome the FRC undertaking the valuable exercise of "tiering" signatories depending on compliance, we believe that a further step should be taken to revise and update the Code itself, not least in order to reflect the Government's interest in a corporate sector and investment sector that help achieve an economy that works for all.

In our experience of reviewing compliance with the Stewardship Code we have found a number of issues which could be resolved by re-drafting sections of the Code and by introducing "best practice" guidance on its application. We would be happy to explain in more detail our findings and proposed solutions, but in brief, we have found that signatories often produce only vague and high-level policies and reporting which does little to reveal how they are operating as effective stewards. We believe that this reflects a wider view that the Code is a tick-box exercise and that it is not a serious driver to improved stewardship. One major problem is that the Code makes no real distinction between asset managers and asset owners (such as pensions funds), with both signing up to the same Code. However, in practice these actors play distinctive roles and undertake stewardship in different ways, and the result is that asset owners' compliance statements and reports may give very little useful information about what they do. This adds to the false impression that stewardship is not really something that asset owners, including pension funds, need to be concerned about.

We therefore suggest that the FRC revises the Stewardship Code so that it promotes appropriate stewardship by different types of institutional investor and on the full range of factors that directors of companies may have regard to in s.172 Companies Act 2006.

Giving savers a voice

As noted above, millions of working people with pension savings have an ownership stake in the UK economy. However, the lack of accountability between savers and those investing their money leaves people disconnected and prevents them from acting as a positive check to hold companies to account. Giving savers a legitimate voice in the system would help to drive out bad practice in both the investment and the corporate sector, contribute to better returns for savers (as demonstrated in other jurisdictions), and help to create an economy which works for everyone. As the Green Paper notes, the UK public do care about corporate governance issues. However, the barriers and agency problems within the investment system are such that there is no useful mechanism by which these concerns can be translated into feedback for companies.

ShareAction therefore urges the Government to re-connect hardworking savers with the institutions investing their money and, in turn, with the companies in which they invest. This could be achieved by the following measures:

- **Including saver representatives in the governance structures of all types of pension schemes.**
- **Giving savers rights to know, on request, standardised information on where their money is invested and how the rights attached to shareholdings are being exercised to influence companies.**
- **Requiring pension schemes to engage with savers through pension scheme Annual Member Meetings, surveys, roadshows and by using clearer communications, including digital platforms.**

Again, we would welcome the opportunity to provide further information about each of the above. In particular, we have drawn up draft legislation in relation to the second proposal on savers' rights to information. The overall message is that we see a need and an opportunity to establish an investment system in which the ordinary people providing capital, who are working in UK companies and impacted by company actions, can hold to account those managing their money and the companies in which it is invested. On the issue of executive pay, which the Green Paper rightly notes is of great concern to many ordinary people, pension savers currently have no rights to information on how their pension scheme cast votes at FTSE 100 companies. Would pension funds and their fund managers vote differently if they felt more accountable to the people whose money they are investing? What if they had to answer these individuals' questions on their voting records, just as company directors have to answer to shareholders at AGMs?

Investors' duties

There is one final issue which ShareAction believes needs to be addressed in order to stop institutional shareholders acting like absentee landlords. This is the issue of investors' duties. In respect of pension trustees, the Law Commission has already clarified that their duties extend beyond maximising short-term financial gain. And the FCA's interim report on its market study into the asset management market recommends a strengthened duty to act in the best interests of clients. These are positive moves, but there is still debate and confusion in the market about what such duties mean in practice. ShareAction has long advocated that investors' duties should be clarified in statute and we urge the Government to take up the opportunity presented by the recently passed IORPs Directive to clarify the law around pension trustees' duties. Again, we would be happy to discuss this in more detail.

In summary, we urge the Government to:

- **Clarify in statute that pension scheme duties to act in the best interests of savers do not prevent them taking into account factors driving long-term financial performance of companies, including environmental, social and governance concerns.**
- **Endorse the strengthening of the FCA's rules so that savers' best interests are put first in all pension schemes.**

Responses to Green Paper, Q.1 and Q.2.

The following answers to the specific questions in the Green Paper should be read in the context of the above discussion.

Q.1. Do shareholders need stronger powers to improve their ability to hold companies to account on executive pay and performance? If so, which of the options mentioned in the Green Paper would you support? Are there other options that should be considered?

ShareAction does not believe that shareholder voting powers on executive pay need to be increased in strength or frequency. In fact, there is a risk that increasing frequency would further incentivise short-termism by executives keen to demonstrate progress. We believe that the apparent disengagement by some shareholders with the issue of pay is a symptom of a wider problem: institutional shareholders need to be encouraged to be more diligent stewards of companies, with higher quality engagement on issues affecting the long-term success of the company and improved reporting all the way back to the ultimate providers of capital i.e. pension savers. The FRC's Stewardship Code should facilitate this, but it has so far failed to do so to the extent envisaged when the Code was first established. We note that the Green Paper proposes amending the FRC's Corporate Governance Code on the issue of pay. We are not opposed to this, but believe a more effective and far reaching change would be to the Stewardship Code. This needs to be amended to properly reflect the differences between asset managers and asset owners. It also needs to facilitate clear, impactful policies on stewardship on the full range of factors to which directors of companies may have regard under s.172 Companies Act 2006.

Q.2. Does more need to be done to encourage institutional and retail investors to make full use of their existing and any new voting powers on pay? Do you support any of the options mentioned? Are there other ideas that should be considered?

ShareAction strongly supports Option (i) (Mandatory disclosure of fund managers' voting records at AGMs and the extent to which they have made use of proxy voting). We also support the suggestion to improve how voting records are reported, including providing rationales for voting decisions. In our experience of tracking compliance with the Stewardship Code, disclosure of voting records is patchy and even when records are disclosed, they are often difficult to navigate or understand. For example, often the resolutions voted on are listed only by number and with no text, so you have to separately search for the AGM voting resolutions on a company's website.

We have previously produced an analysis of how voting records could be improved, including designing a standard template for disclosure. We do not believe any particular template should be mandated, but we believe there is value in the FRC providing something similar for investors to use if they wish and as an example of best practice. We would be pleased to provide further details if it would assist.

We also support the suggestions at paragraphs 1.40 and 1.41, Option (iii) (Consider ways to facilitate or encourage individual retail shareholders to exercise their rights to vote on pay and other corporate decisions). We draw your attention to the Green Paper response of Mr. Barrie Stead, who has invaluable first-hand experience of the issues individual shareholders face and who has developed a robust and workable solution to some of these.

Greater pressure could also be applied to encourage institutional shareholders to make use of their voting rights by re-connecting savers with those investing their money. We refer you to the discussion above and the solutions suggested there (e.g. Pension scheme annual member meetings, greater rights to information and saver representation in pension scheme governance structures).

We hope that the above discussion has provided ideas which the Government will investigate as it develops practical policies that will fulfil the Prime Minister's vision of an economy that works for all. We would be delighted to assist in any way we can.

Kind regards,

Catherine Howarth
Chief Executive