ShareAction
the movement for Responsible Investment

16 Crucifix Lane
London, UK
SE1 3JW
+44 (0) 20 7403 7800

Industrial Strategy Team
Department for Business, Energy and Industrial Strategy
1 Victoria Street
London
SW1H 0ET

Sent by email to industrial.strategy@beis.gov.uk

13 April 2017

Dear Sir or Madam,

Building our Industrial Strategy Green Paper

I am writing to respond to the Green Paper on Building our Industrial Strategy on behalf of ShareAction, a registered charity established to promote transparency and responsible investment ("RI") practices by pension funds and other institutional investors. We are a member organisation and count amongst our members well-known NGOs and charitable foundations, as well as over 26,000 individual supporters. We work with asset managers and institutional investors to promote stewardship and engagement, and we also conduct annual industry-wide surveys to rank them on these activities. We recently gave evidence to the BEIS Select Committee on their corporate governance inquiry. We have extensive experience of research and policy development on barriers to long-termism, and fed into both the 2012 Kay Review and the related BIS Select Committee.

We would like to respond to the question in the above paper relating to the factors constraining quoted companies and fund managers from making longer term investment decisions.

19. What are the most important factors which constrain quoted companies and fund managers from making longer term investment decisions, and how can we best address these factors?

Introduction

We are pleased to see the Government has launched the Patient Capital Review to address barriers to the growth of long-term investment. We strongly agree that aspects of the investment chain, such as incentives in fund management, undermine long-term decision-making which results in short-term pressures on company boards.

A healthy corporate culture is key to sustainable growth, as recognised in the FRC's 2016 report on this subject.[i] However, the report also found that "excessive focus by shareholders on short-term performance – or the perception that this is the case – can be a driver of poor behaviour" and "most asset managers reported… that their clients rarely put them under pressure to put resources into engaging on corporate culture."[ii] This echoes the findings of Professor Kay's 2012 review of short-termism in equity markets following the 2008 crash.

While we very much welcome proposed measures to increase stakeholder involvement in corporate governance in the Government's Green Paper on Corporate Governance, we believe the shareholder's role may be the most effective point of intervention. Company law is constructed around the concept of shareholder primacy, and it is shareholders who have the greatest influence over company behaviour and cultural norms.[1] The Companies Act 2006 sought to introduce an era of enlightened shareholder value, in which companies and their directors would focus on long-term success and consider the impacts on wider stakeholders such as staff, suppliers, communities and the environment. Such a regime depends on having enlightened and accountable shareholders, incentivised to look to the long-term sustainability of companies.

However, in practice, a lot of fiduciary investors continue to think that they have a single overriding duty to maximise short-term profitability.[2] This results in short-term pressures that flow down to companies. Some institutional investors operate conscientiously as stewards of companies, but many institutional shareholders are absentee landlords, lacking incentives to take the trouble to steward large companies with care and diligence.

We observe a range of symptoms of the system not working as well as it could:

- Many shareholders do not exercise their voting rights (28% within FTSE 100 companies[iii]) or do not exercise those rights to rein in board excesses (on average 93% voting in favour of remuneration reports and policies since 2013[iv]).
- There is a wide gulf between the best and worst practice in respect of stewardship of companies by institutional investors.[v]
- Asset managers are driven by their own short-term pressures, resulting in corresponding pressures on companies.
- Directors of many companies only pay lip-service to their Companies Act duties to consider the interests of wider stakeholders in pursuing the success of the company.

Our long-standing work on investors' duties and institutional investors' incentives suggest that it is principally agency problems in the investment chain and prevailing interpretations of fiduciary duties that currently undermine enlightened company behaviour.

The agency problem

It is often said that there is an agency problem within the investment system. The 2012 Kay Review[vi] identified a problem of "short-termism" in UK capital markets,[vii] where investment managers invest on the basis of short-term movements in share price as opposed to the fundamental value of the company.[viii] It said, "The interests of beneficiaries are largely interests in long-term absolute performance. The concern of asset managers – and the basis on which they are monitored by many asset holders, and by advisers to asset holders and retail investors – is short term relative performance. This misalignment of incentives creates many problems."[ix] This was recently acknowledged by the FCA in its interim report for its market study of the asset management industry,[x] which highlights that fund managers' interests are often poorly aligned with their clients' interests.

Lack of clarity of fiduciary duties

Professor Kay also noted that some pension fund trustees demonstrated a narrow interpretation of their fiduciary responsibilities, prioritising short-term financial returns over financially material factors which might impact on the long-term performance of investments.

[1] Academic research indicates that large shareholders can be important and powerful corporate monitors because they have influence and incentives to incite change in corporate behaviour due to their large stake in targeted firms. (Burkhart, M., Gromb, D., and Panunzi, F. (1997). Large shareholders, monitoring, and the value of the firm. The Quarterly Journal of Economics, 112(3), pp. 693-728; Shleifer, A. and Vishny, R. (1986) Large Shareholders and Corporate Control. Journal of Political Economy 94(3), pp. 461-488.94(3); Deutsche Bank Group (2012) Corporate Engagement by Institutional Shareholders.)

[2] In the process of producing our 2016 survey on auto-enrolment providers, we had access to some providers' internal investment policy documents and found evidence that fiduciary duty is still being viewed as the duty to generate the best possible financial returns for members.

The Kay Review recommended that the Law Commission should be asked to review the legal concept of fiduciary duty as applied to investments to address uncertainties and misunderstandings on the part of trustees and their advisors. In its own review, the Law Commission recognised that the law is complex and inaccessible[xi] and this "may lead trustees to be overly narrow in their approach to investment factors and to their beneficiaries' concerns".[xii] It in turn recommended that the Government reviewed aspects of the Occupational Pension Schemes (Investment) Regulations 2005, including clarifying the statutory language around trustees taking account of environmental, social and governance factors in investments.[xiii] However, the Government rejected this recommendation,[xiv] citing a lack of consensus among respondents to its consultation on the issue.[3] Since it is unlikely that many trustees and their advisors will refer to the Law Commission's review in assessing the scope of their fiduciary responsibilities, the issue remains uncertain and trustees are likely to continue interpreting their duties narrowly, to the potential detriment of the long-term performance of fund investments. This is consistent with our experience of the institutional investment sector.

To illustrate this, only 21% of trustees and pension investment professionals in a recent snapshot industry survey we worked to develop with Professional Pensions said that environmental, social and governance (ESG) factors, which are often most relevant to investment performance over the medium to long term, were fully embedded in their investment approach. 39% said they do not take ESG factors into account and are not considering doing so.[xv]

Transparency and accountability

We need to look down the investment chain to the factors motivating fund managers. One of the most significant areas of investment in capital markets is by pension funds, which predominantly use fund managers. They are naturally long-term investors but are not necessarily acting as such. An article in the *OECD Journal: Financial Market Trends* commented: "supposedly long-term institutional investors are also recurrently being labelled as 'short-termist', of feeding asset price bubbles with a herd-like mentality and of being 'asleep at the wheel' as company managers abuse their power to the detriment of shareholders. One key feature of institutional investors – especially the smaller ones - is that they rely on asset management firms for a large part of their investments… Control over external asset managers is often focused on short-term performance monitoring, leaving day-to-day investment decisions in the hands of professionals who may not always have the best interest of the ultimate asset owners in mind."[xvi]

Many pension funds have investment horizons of multiple decades: a 25 year old saving for their pension has an investment horizon of 40 years. Yet on average, pension fund investors say they stay invested for a little more than four and a half years[4]. 22% of funds say they have a time horizon of five to 10 years, but 8% have a time horizon of just six to 12 months and 20% say they have no specific timeframe for holding investments.[xvii] To put this in context, a timeframe of five years is usually suggested as the minimum for equity market investment, on the basis this allows investors to experience the ups and downs of a normal market cycle. Analysis by Ritholtz Wealth Management of the S&P 500 between 1927 and 2014 shows the benchmark US index recording positive returns across 88% of all five-year periods. That figure rises to 94% for 10-year periods, while there has yet to be a negative return over a 20-year timeframe.[xviii]

One problem is a lack of accountability to people providing the money and weak oversight in the market. Savers have little capacity to scrutinise decisions not being made in their best interests. They are not treated as the customers of their pension schemes: they usually have

[3] However, our analysis indicated that 43 of 47 respondents called for changes to be made to the Investment Regulations, with 37 of these 43 respondents emphasising the importance of long-term risks being taken into account by pension fund trustees when making investment decisions.

little choice about which provider manages their money, as this is chosen by their employer, and they receive little meaningful information about how their money is invested. They are not able to switch providers (without losing their employer's contribution) and by the time they are in a position to discover poor performance, it is too late for them to do anything to resolve it. They have no forum for offering comments on how ownership rights are being exercised on their behalf. Even if engaged savers take the time to approach their pension providers to ask direct questions about how their money is being managed, they often receive vague and boilerplate responses that do not give them the answers they seek.[5]

We have also seen a wholesale change in pensions governance, with a rollback of protections put in after the Maxwell scandal. Nobody with 'skin in the game' is represented in the governance structures of master trust and contract-based schemes – and with savers bearing all the risk and costs of investment, the increasing number of employers with defined contribution (DC) schemes have little incentive to oversee scheme practice and ensure it is effective. This is illustrated by research from The Pensions Regulator which found that in schemes with both defined benefit (DB) and DC elements much more time was spent on DB issues (ten days on average) compared to DC issues (two days).[xix]

Our recommendations

ShareAction has been working with parties at the forefront of responsible investment and corporate governance for 10 years. Our research into the stewardship behaviour of major institutional investors and our work with small numbers of motivated and well informed pension savers is the backdrop to our policy proposals. In our experience, these measures would create the conditions for companies to be positively influenced by their major shareholders far more than happens today. We would be happy to provide more detail on each of these proposals. In particular, we have given considerable thought to how they might be implemented. None require primary legislation, albeit we can see potential political merit in a "Responsible Investment Bill".

The key measures proposed are as follows:

- **Clarify investors' fiduciary duties in law**
    - Following the Kay Review, the Law Commission recommended that DWP amend the Occupational Pension Schemes (Investment) Regulations 2005 to clarify that there is no barrier to pension fund trustees taking account of ESG issues that are relevant to savers' best interests. DWP consulted and decided not to amend the law so. This means that these regulations are now out of step with the rules for local government schemes (which better reflect the Law Commission's findings). There has been widespread criticism of DWP's decision, including from the Law Commissioner who led the review. Many share our view that confusion on fiduciary duties continues to pose a barrier to funds taking account of longer-term factors, including ESG issues, and thus mandating their asset managers to do so.
    - As part of its ongoing review of the asset management industry, the FCA has proposed a strengthened duty on asset managers to act in clients' best interests. Doing so would ensure that there is no "gap" in the investment chain in respect of fiduciary duties and would help to eradicate some of the

[5] Legal & General's October 2016 survey found 95% of scheme members would like their employer to provide more communication on their scheme's philosophy, actions, where their money is invested, and the impact it is having. Only half currently believe they receive ample communication. After assessing what choices are important and whether they have been given options, 72% consider they would be likely to move or recommend to their employer moving to a responsibly investing pension. 84% would prefer a pension that uses investments to encourage companies to be more responsible. When deciding amongst different pension options, 76% would opt for the one that is a more responsible investor. (http://www.legalandgeneralgroup.com/media-centre/press-releases/press-releases.asp?newsid=2973.)

rent extraction and non-competitive behaviour in the asset management industry.

- **Amend the Stewardship Code and enforce it more actively**
    - The FRC may review the Stewardship Code in 2018. However, we think this should be done in parallel with its 2017 review of the Corporate Governance Code, as these two codes are entirely complementary. The Stewardship Code is the less mature and weaker of the two codes but its role is critical in making a success of corporate governance in the UK. The current Stewardship Code does too little to encourage best practice by investors, and there is no consequence or "bite" for investor non-compliance. Both the Code and the sanctions for non-compliance should be reviewed and strengthened. We were pleased to see that the BEIS Select Committee's report on corporate governance includes our recommendation to review the Stewardship Code.

- **Increase transparency and accountability of institutional shareholders**
    - Include saver representatives on the governance structures of all types of pension scheme. Currently this is only in place for single employer schemes whose role is shrinking in an auto-enrolment era. Putting suitably qualified and competent savers on the boards of their pension schemes is a different proposition from putting workers on company boards, but it would allow the government to show it sees a role in investment governance for working people with 'skin in the game' as pension savers. It would also contribute to diversity of thinking in pensions governance. The best performing pension systems in the world (Denmark, Australia, Canada) all have savers on the boards of pension schemes.
    - Give savers the right to know, on request, information about where their pension money is being invested and how the rights attached to shareholdings are being used to influence companies.
    - Require pension schemes to engage with savers proactively about their investments and engagement activities, e.g. through annual member meetings, roadshows and digital platforms. Again, high performing pension systems around the world use all these measures to make pension schemes accountable.
    - Institutional shareholders should be required to disclose publicly how they vote at company meetings (the Government has reserve powers to do this). Such disclosure should be mandated to happen in a timely and standardised manner.

Further evidence supporting the proposals outlined above

If we want directors of companies to operate with a longer-term focus, we must examine and address the motivations of those to whom directors are accountable. Examples of enlightened shareholder behaviour exist. Indeed, we observe a broadly positive trend in respect of stewardship behaviour. However, more needs to be done to encourage it. The following are some recent examples of enlightened shareholder behaviour, often resulting in tangible change in a company's behaviour:

- Shareholders in Rolls-Royce plc undertook comprehensive engagement focused on concerns around long-term strategy and profitability. This resulted in the new CEO taking action to stabilise the business[xx]. The Investor Forum led this initiative.

- Following the rapidly aborted takeover bid by Kraft of Unilever, several longstanding pension investors in Unilever have emphasised in an open letter to the company's board that it should refrain from responding to this bid by increasing short term shareholder value at the expense of its long-term strategy and value.[xxi]
- Reckitt Benckiser cut the pay of its CEO by 50 percent ahead of its 2017 AGM, in response to shareholder engagement around pay, in light of the company's performance and scandal in South Korea over faulty products.
- Aviva Investors, amongst others, encouraging companies to become accredited Living Wage employers. Aviva report that their engagements with Unilever, Experian and BG Group have resulted in their accreditation.[xxii]
- Hermes Investment Management, Aviva Investors, AXA Investment Managers and CalSTRS joint engagement with Apple supplier Hon Hai (Foxconn) about poor working conditions and poor corporate governance has led to the company being independently verified on its employee relations (with ongoing work acknowledged), increasing transparency and producing a sustainability report as requested by the shareholders.[xxiii]
- The "Aiming for A" coalition of shareholders in BP and Shell led to the tabling and passing of shareholder resolutions at these companies, mandating disclosure of business risks against climate change.

(See also further examples in the Investor Forum's 2015/16 review: IF REVIEW)

The above positive examples of stewardship behaviour are driven by mounting evidence that taking into account environmental, social and governance (ESG) factors is financially astute[xxiv].

We would be happy to meet to discuss any of the views raised in this response.

Yours sincerely,

Rachel Haworth

REFERENCES

[i] Financial Reporting Council (July 2016). *Corporate culture key to sustainable growth*. Available online at: https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2016/July/Corporate-culture-key-to-sustainable-growth.aspx [accessed 13 April 2017].

[ii] Financial Reporting Council (July 2016). *Corporate Culture and the Role of Boards*, p31. Available online at: https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Corporate-Culture-and-the-Role-of-Boards-Report-o.pdf [accessed 13 April 2017].

[iii] Department for Business, Energy and Industrial Strategy (November 2016). *Corporate Governance Reform*, p19. Available online at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/584013/corporate-governance-reform-green-paper.pdf [accessed at 13 April 2017].

[iv] Ibid, p 26.

[v] ShareAction (January 2016). *Responsible Investment Performance of UK Asset Managers*. Available online at: http://shareaction.org/wp-content/uploads/2016/01/AssetManagerSurvey2015.pdf [accessed 13 April 2017].

[vi] Kay, J. (July 2012). *The Kay Review of UK Equity Markets and Long-Term Decision Making*. Available online at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf [accessed 13 April 2017].

[vii] Ibid, p9.

[viii] Ibid, p11.

[ix] Ibid, p41.

[x] Financial Conduct Authority (November 2016). *Asset Management Market Study: Interim Report*. Available online at: https://www.fca.org.uk/publication/market-studies/ms15-2-2-interim-report.pdf [accessed 13 April 2017].

[xi] Law Commission (June 2014). *Fiduciary Duties of Investment Intermediaries*, p 10. Available online at: http://www.lawcom.gov.uk/wp-content/uploads/2015/03/lc350_fiduciary_duties.pdf [accessed 13 April 2017].

[xii] Ibid, p128.

[xiii] Ibid, p239.

[xiv] Department for Work and Pensions (November 2015). *Better Workplace Pensions: Reducing regulatory burdens, minor regulation changes, and response to consultation on the investment regulations*. Available online at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/476447/reducing-regulatory-burdens-and-misc-regs-nov-2015-consultation.pdf [accessed 13 April 2017].

[xv] Professional Pensions. (August 2016). Climate change is 'overblown nonsense' and not a material risk, says industry. Available online at: http://www.professionalpensions.com/professional-pensions/news/2468851/climate-change-isoverblown-nonsense-and-not-a-material-risk-says-industry [accessed 13 April 2017].

[xvi] Della Croce, R., Stewart, F., Yermo, J. (2011). *Promoting Longer-Term Investment by Institutional Investors: Selected Issues and Policies*, p2. Available online at: http://www.oecd.org/finance/private-pensions/48616812.pdf [accessed 13 April 2017].

[xvii] Schroders (2016). *Global Investor Study 2016 – Plan Sponsors*, p4. Available online at: http://www.schroders.com/en/sysglobalassets/digital/insights/2016/pdfs/global-investors-study-pension-funds.pdf [accessed 13 April 2017].

[xviii] Schroders (2016). *Global Investor Study 2016*, p4. Available online at: http://www.schroders.com/fr/sysglobalassets/digital/insights/pdfs/2016/sgis-2016/sgis-investment-outcomes-full-report.pdf [accessed 13 April 2017].

[xix] The Pensions Regulator. (October 2015). *Trustee Landscape Quantitative Research: A report on the 2015 Trustee Landscape research*. Available online at: http://www.thepensionsregulator.gov.uk/docs/trustee-landscape-quantitative-research- 2015.pdf [accessed 13 April 2017]

[xx] The Investor Forum (2016). *Review 2015-2016*, p20. Available online at: https://media.wix.com/ugd/1cf1e4_661b01aaeab94b47b72d10b14e8de45d.pdf [accessed 13 April 2017].

[xxi] Van Wijk, M. IPE (28 February 2017). "Pension funds urge Unilever to stick to long-term policy". Available online at: https://www.ipe.com/countries/netherlands/pension-funds-urge-unilever-to-stick-to-long-term-policy/10017758.article [accessed 13 April 2017].

[xxii] Aviva Investors (2016). *Annual Review 2015*, p15. Available online at: https://www.avivainvestors.com/content/dam/aviva-investors/united-kingdom/documents/ai-responsible-investment-review-2015.pdf [accessed 13 April 2017].

[xxiii] Hermes EOS (March 2016). *Annual voting and engagement report*, p13. Available online at: https://www.hermes-investment.com/wp-content/uploads/2016/03/Annual-Report-2015.pdf [accessed 13 April 2017].

[xxiv] See, for example: Deutsche Asset & Wealth Management (December 2015). *ESG & Corporate Financial Performance: Mapping the global landscape*. Available online at: https://institutional.deutscheam.com/content/_media/K15090_Academic_Insights_UK_EMEA_RZ_Online_151201_Final_(2).pdf [accessed 13 April 2017]; and Arabesque Partners and University of Oxford (2015). From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance. Available at http://www.longfinance.net/programmes/london-accord/la-reports.html?view=report&id=464 [accessed 13 April 2017].