

Institutional Investors and Corporate Governance

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Institutional Investors and Corporate Governance

- **Within an investee company**
 - risk controls
- **By shareholders**
 - setting a voting policy
 - seeking advice: proxy voting
 - implementation, monitoring and reporting
 - expectations, requirements and standards
- **Expectations of stakeholders**
- **Stock lending and voting issues**

Definitions and Developments

- **Corporate Governance**
- **Institutional Investor: responsible investor and /or responsible investment**
- **ESG: Environmental, Social & Governance**
- **SRI: Socially Responsible Investment**
- **UNPRI**
- **FRC: Financial Reporting Council: Stewardship Code**
- **FSA > 2013 split into Prudential Regulation Authority & Financial Conduct Authority**
- **LAPFF**
- **ICGN**
- **Kay Review: BIS/ short – termism?**

Looking at the long term value of a business in which the Fund has invested

Corporate Governance: companies

Bad Corporate News?



Questions to ask/understanding the risks:

Roles played by the:

- non-executive directors?
- internal auditors and compliance
- external auditors
- shareholders? Reputational risk

Corporate Governance

Institutional Investors

- **SRI (Socially Responsible Investment) is only a part!**
 - tobacco, arms trade etc: if you don't like, you needn't invest
 - the green agenda, sustainability,
- **wider fiduciary responsibilities (2005 Freshfields: ESG considerations)**
 - can build ESG into investment selection processes
 - local economy? Infrastructure?
- **wider stakeholders' interest: lobbying? Individual members?**
- **Shareholder Engagement**
long termism: not short-term unsustainable profits

Corporate Governance Institutional Investors

- UNPRI
- Myners Principles 2001 (10), 2008 (6)
>>>”Activism” and subsequent influence on >>>
- UK Stewardship Code 2010, 2012

and, for the LGPS

- *Application of Myners Principles to Management of LGPS funds*
- *Statement of Investment Principles (SIP)*
- *CIPFA Pensions Network Guidance*
- *CIPFA Knowledge & Skills Framework*



Corporate Governance Institutional Investors

United Nations Principles for Responsible Investment (UNPRI)

- **6 principles especially focussed on environmental, social & governance factors (ESG)**
- **integrate ESG into investment analysis**
- **active ownership, engagement strategy**
- **seek effective ESG disclosures**
- **work with others: report progress**

Corporate Governance Institutional Investors

Myners Principle 5: Responsible Investment

- **Adopt, or ensure their investment managers adopt, the Institutional Shareholders' Committee Statement of Principles on the responsibilities of shareholders and agents,**
- **Include a statement of their policy on responsible ownership in the Statement of Investment Principles; and**
- **Report periodically to scheme members on the discharge of such responsibilities**

Corporate Governance Institutional Investors

Stewardship Code: Financial Reporting Council (FRC)

- Introduced July 2010
- best practice principles intended to frame both shareholder engagement with companies and its disclosure

Aims:

- Enhance the quality of engagement between institutional investors and companies
- Help improve long term returns to shareholders
- Efficient exercise of governance responsibilities

Basis: “Comply or Explain”

BUT : Not obligatory (under review)

Corporate Governance Institutional Investors

Stewardship Code: Financial Reporting Council (FRC)

Institutional Investors should:

- 1. Publicly disclose their policy on how they will discharge their stewardship responsibilities**
- 2. Have a robust policy for managing conflicts of interest in relation to stewardship and this policy should be publicly disclosed**
- 3. Monitor their investee companies**
- 4. Establish clear guidelines on when and how they will escalate their activities as a method of protecting & enhancing shareholder value**
- 5. Be willing to act collectively with other investors**
- 6. Have a clear policy on voting and disclosure of voting activity**
- 7. Report periodically on their stewardship & voting activities**

Corporate Governance Institutional Investors

Stewardship Code: Financial Reporting Council (FRC)

- **Current Review of CG Code and Stewardship Code (July 2012)**
- **Stewardship Code Revision 2012 (draft)**
 - **set out use of proxy voting advisory services**
 - **set out policy for voting on stock out on loan**
 - **changes expected for reporting periods commencing October 2012 onwards**

EU dimensions:

- **EU tends to focus on legislation rather than “comply or explain”**
- **draft Market Abuse Directive: could the UK Stewardship Code be interpreted as Insider Dealing? Unintended consequences?**

Local Authority Pension Fund Forum

- **LAPFF exists to promote the investment interests of local authority pension funds, and to maximise their influence as shareholders whilst promoting social responsibility and corporate governance at the companies in which they invest.**
- **Formed in 1990, the Forum brings together a diverse range of local authority pension funds with combined assets of over £100 billion**
- **55 LGPS Funds are members**
- **“Delegating Shareholder Engagement: Holding Fund Managers to Account”**
- **Now a high - profile organisation**

Shareholder Voting

- **Set an overall policy, make it transparent and adhere to that policy**
- **Report on outcome of that policy: Myners Principle 5**
 - voting records? evidence?
- **Voting in other jurisdictions: enough knowledge & guidance?**
- **“Segregated holdings”:** direct voting
- **Holdings within “pooled funds”**
 - more complex: follow the approach of fund manager?
 - or ask whether “your underlying holding” can be separately voted
- **Use of Proxy Voting agent**

Shareholder Voting

PROXY VOTING

- **Plenty of choice:** PIRC, Manifest, ISS, Robeco etc
- **Convenient:** saves Fund time
- **Custodian: needs informing from whom instructions are to be taken,**
Fund? Proxy Agent? Or for pooled funds, asset manager may use
own custodian.

Proxy Voting Agents' Role under Scrutiny? Regulatory Framework? –

Voting agencies engage with companies, but do they have power without an economic interest? Do asset owners challenge their guidance?

- **UK: Revision of Stewardship Code**
- **EU: ESMA Discussion Paper March > June 2012**

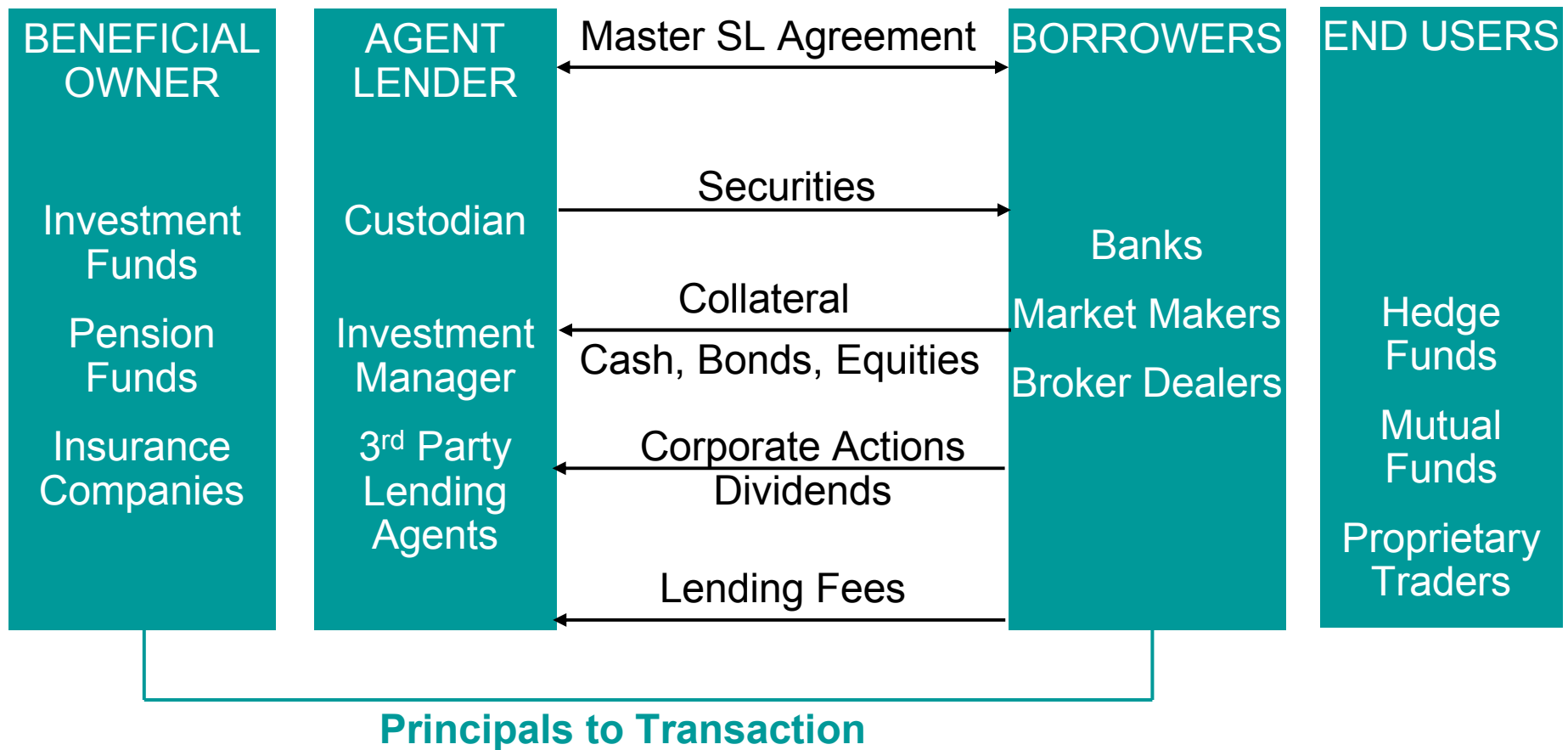
Stock Lending

- Enables long term holders to benefit from short term demand for their securities, whilst retaining an economic interest (entitlement to dividends & other corporate actions)
 - Involves a temporary loss of title, in exchange for an irrevocable undertaking to return equivalent securities, plus either:
 1. a fee plus non-cash collateral (government bonds, equities) or
 2. cash collateral, to re-invest, make a turn, & return to borrower or
 3. a guaranteed fixed income flow for the year
- NB lender can recall when required, borrower can return when appropriate : vast majority are “on call”
but also “term loans” : pre-agree not to recall over a specific event e.g. over a scrip dividend option period

Stock Lending – what is it?

Lender (Supply)

Borrower (Demand)



Stock Lending

- **Allowed within LGPS Investment & Management of Funds Regulations 2009: limits apply**
- **SIP to show lending policy and associated risks & mitigation**
- **A discretionary activity: for segregated holdings, Fund can decide:
- whether to lend, what to lend, when to lend, when to recall.**
- **Endorsed by Regulators including Bank of England**
- **LAPFF is a member of International Securities Lending Association (ISLA)**
- **Educational documents available, plus CIPFA Training Events
(Myners Principle 1: effective decision making)**
- **Stock Lending (=Securities Lending) is an investment function**



Stock Lending

Collateral

- Includes a margin over the value of lent securities
- “marked to market” daily, collateral level adjusted
- Europe: mainly non-cash collateral
- USA: almost entirely cash collateral
- 2008 Lehman Bros failure was the stress test
- the “system” passed the test, no LGPS fund lost money
- regular reports on collateral by type and by lender
- seek a solid indemnity against loss
- but lack of due diligence on cash re-investment caused some losses (mainly USA):
- generally, no indemnity given against cash collateral

Stock Lending

Procurement & Routes to Market

- **Most common route: via Fund's Global Custodian**
- **One LGPS Fund lends some stocks directly to market**
- **Specialist third party lenders**
- **Other custodians as third party lender**
- **Procurement Options: separate contract from global custody services?**
- **Lending value varies according to type of holdings**
- **Best value: separate analysis of securities lending income?**
 - **who can accurately predict future levels of demand?**
 - **future "hot stocks"?**
 - **an activity in its own right: not just to offset costs of custody**

Stock Lending Governance

Fund's Governance Policy: Lenders should set out their voting policy for stock out on loan

- Consider “costs of voting” i.e. borrowing fee lost when stock is recalls, relative to “benefits of voting”**
- Software program can quantify loss of fee income**
- Arrive at your policy, and apply it consistently**
 - e.g. - recall all stock for voting, or**
 - recall all UK stock for voting, or**
 - recall only when voting against management or**
- Be mindful of recall deadlines in other jurisdictions**

NB Governance issues also relate to pooled funds