

Institutional Investors and Corporate Governance

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Institutional Investors and Corporate Governance

What we shall cover:

- **Definition of corporate governance for a local authority pension fund**
- **Investment objectives and implementation within LGPS: relevant legal powers**
- **Issues and concerns with companies in which we've invested: risk controls**
- **Engagement & Action by shareholders (asset managers & underlying owners)**
 - **enhancing long term shareholder value**
 - **multi dimensional: responsible investor / responsible investment**
 - **setting a voting policy and seeking advice: proxy voting**
 - **implementation, monitoring and reporting**
 - **expectations, requirements, accountability & standards**
- **Expectations of stakeholders**
- **Stock lending and voting issues**

Definition

Corporate Governance for the LGPS

(similar to the local authority!)

- How the Administering Authority ensures it does the right things in the right way for the right people in a timely, inclusive, open, honest and accountable manner
- It comprises the systems, processes, culture and values by which the Pension Fund is directed and controlled, and through which it accounts to and engages with and where appropriate leads its communities

What's What? Whose Who?

- **Corporate Governance (the chain: investee companies/asset manager/end investors)**
- **Institutional Investor: responsible investor and /or responsible investment**
- **ESG: Environmental, Social & Governance**
- **SRI: Socially Responsible Investment**
- **Board Diversity (Equality & Human Rights Commission Aug 2014)**
- **UNPRI/ PRI: United Nations Principles for Responsible Investment**
- **FRC: Financial Reporting Council > Stewardship Code**
- **Prudential Regulatory Authority (PRA) & Financial Conduct Authority (FCA) : previously FSA**
- **LAPFF: Local Authority Pension Fund Forum**
- **ICGN: International Corporate Governance Network**
- **Kay Review: BIS/ short – termism?**

Looking at the long term value of a business in which a pension 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
- investment banking advisers
- shareholders? Reputational risk

LGPS Investment Powers and Purposes

Wider fiduciary responsibilities: Counsel's advice to LGPS Shadow Scheme Advisory Board:

- **fiduciary responsibilities to both scheme employers and scheme members**
- **Powers of investment for investment (not any wider) purposes**
- **Aim to achieve wide variety of suitable investments while balancing risks and rewards**
- **Precise choice of investments may be influenced by wider social ethical or environmental considerations**
- **But must not risk material financial detriment to the Fund**

Responsible Investor and Responsible Investment

INVESTOR

- **Shareholder Engagement: long termism, not short-term unsustainable profits**
- **using your votes /Stewardship**

INVESTMENT

- **wider stakeholders' interest: lobbying? Individual members?**
- **SRI (Socially Responsible Investment) is only a part**
- **Counsel's opinion: Social housing must be justified as an investment in its own right: also local property development**
- **ESG: Environmental, Social and Governance: the green agenda plus... tobacco, arms trade etc: you can avoid investing and select other investments producing a similar return relative to risk**

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/PRI)

- **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: revised 2012: next revision due 2014: maybe
- 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”: not obligatory, but UK authorised asset managers must report on whether or not they comply with the Code. Asset managers have been signing up. 21 LGPS funds have signed up.
No fee payable to become a signatory.

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 which should be publicly disclosed**
- 3. Monitor their investee companies**
- 4. Establish clear guidelines on when and how they will escalate their activities**
- 5. Be willing to act collectively with other investors where appropriate**
- 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)

- **Review of CG Code and Stewardship Code (July 2012)**
- **Stewardship Code Revision 2012**
 - disclose your use of proxy voting advisory services
 - disclose your policy for stock lending and recalling lent stock
 - changes expected for reporting periods commencing October 2012 onwards
- Review of practice May 2014: more asset managers disclosing engagement

EU dimensions:

- **EU tends to focus on legislation rather than “comply or explain”**
- but EU taking an interest in the UK Stewardship Code

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 (60) with combined assets of over £125 billion**
- **Covers climate change & employee engagement as well as more traditional concerns such as corporate governance & executive remuneration**
- **“Delegating Shareholder Engagement: Holding Fund Managers to Account”**
- **Has become a high - profile interventionalist 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
 - LAPFF paper March 2013
 - collective investment vehicles?
- **Use of Proxy Voting agent: convenient, time saving**
- **Custodian needs to know from whom voting instructions will come**

Stock Lending

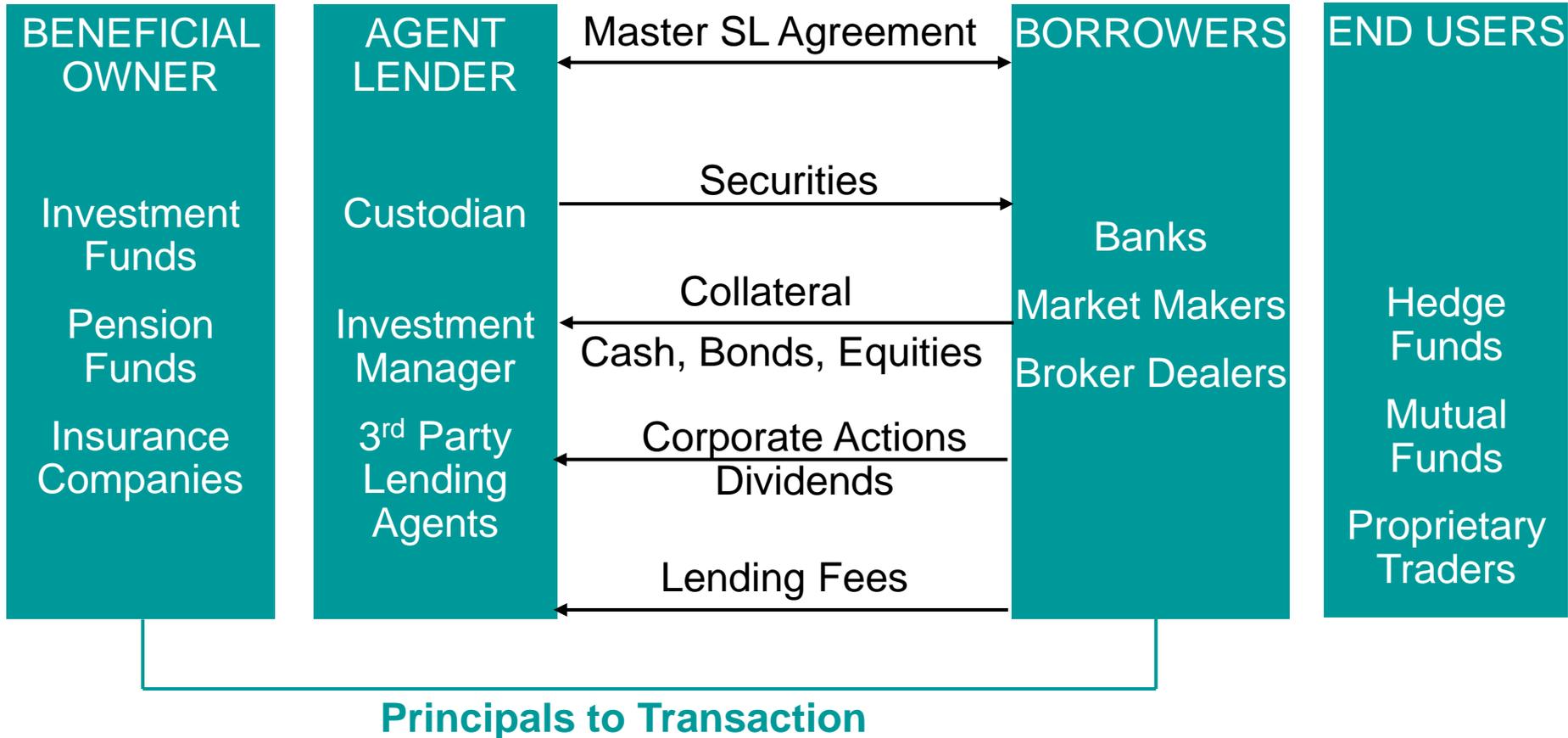
- Enables long term holders to benefit from short term demand for their securities, whilst retaining an economic interest (entitlement to dividends & other corporate actions)
- Involves a temporary loss of title, in exchange for an irrevocable undertaking to return equivalent securities, plus either:
 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?

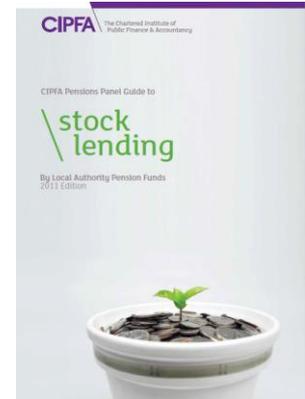
Lender (Supply)

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.**
- **Educational documents available, plus CIPFA Training Events (Myners Principle 1: effective decision making)**
- **Stock Lending (aka Securities Lending) is an investment function: needs in-house expertise: don't be over-reliant on agent lender**



Stock Lending

Collateral

- Includes a margin over the value of lent securities
- Can include equities, bonds or cash
- “marked to market” daily, collateral level adjusted
- regular reports on collateral by type and by issuer
- seek a solid indemnity against loss
- 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 or other custodians as third party lender**
- **Procurement Options: separate contract from global custody services? Framework agreement**
 - **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 recalled, relative to “benefits of voting”**
- **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, e.g. when voting against management
- **Be mindful of recall deadlines in other jurisdictions**
- **NB Don't overlook the lending policy of the asset managers of your pooled funds!**