Institutional Investors and Corporate Governance

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Institutional Investors and Corporate Governance

- **Within an investee company**
  - risk controls

- **By shareholders (asset managers and 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**

Definitions and Dimensions

- **Corporate Governance (investee companies/asset manager/investor)**
- **Institutional Investor: responsible investor and /or responsible investment**
- **ESG: Environmental, Social & Governance**
- **SRI: Socially Responsible Investment**
- **UNPRI/ PRI: United Nations Principles for Responsible Investment**
- **FRC: Financial Reporting Council > Stewardship Code**
- **FSA: Financial Services Authority > 2013 split into Prudential Regulatory Authority (PRA) & Financial Conduct Authority (FCA)**
- **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 the Fund has invested

Corporate Governance: companies

Bad Corporate News?

ABN·AMRO

RBS

The Royal Bank of Scotland

hp

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**

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

<u>and, for the LGPS</u>

- ***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 2014**
- **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.

No fee payable to become a signatory (20 LGPS funds have signed up).

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

<u>EU dimensions</u>:

- **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 (56) with combined assets of over £115 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
- **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:**

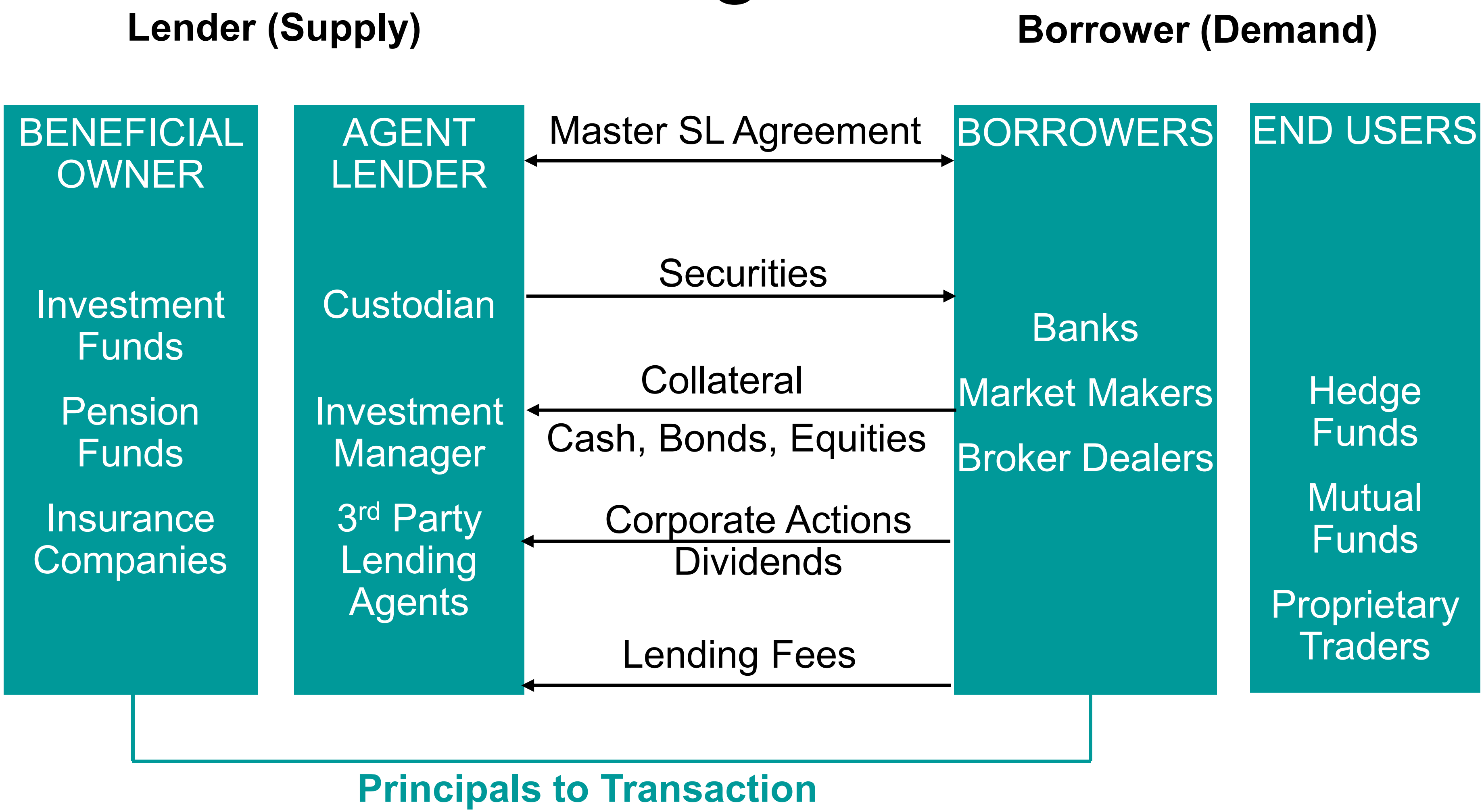
  1. a fee plus non-cash collateral (government bonds, equities) or

  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 "<u>on call</u>"
  but also "<u>term loans</u>" : pre-agree not to recall over a specific event e.g. over a scrip dividend option period

Stock Lending – what is it?



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:**
  not 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 <u>indemnity</u> 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?

  - 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"
- 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!