Local Authority Pension Fund Forum

Response to BIS Review on Corporate Governance and Short-Termism

The Local Authority Pension Fund Forum (LAPFF) was set up in 1991 and is voluntary association of 52 local authority pension funds based in the UK. It exists to promote the investment interests of local authority pension funds, and to maximise their influence as shareholders to promote corporate social responsibility and high standards of corporate governance amongst the companies in which they invest. The Forum's members currently have combined assets of over £90 billion. The Forum has taken the opportunity below to provide our view on those issues which we consider relevant to our activities.

Response

The Board of Directors
1. Do UK boards have a long-term focus – if not, why not?

The Forum believes that most boards do seek to have a long-term focus. However, anecdotal evidence from our engagement with companies suggests that many board members feel (rightly or wrongly) that there is considerable pressure on them to deliver performance in the short term. This in part is due to the short-term mandates in investment management, further driven by quarterly monitoring of the performance of portfolios.

2. Does the legal framework sufficiently allow the boards of listed companies to access full and up-to-date information on the beneficial ownership of company shares?

No. Companies can obtain the relevant information, but this is not straightforward. LAPFF believes that there may be merit in making it easier for companies to identify who their beneficial owners are.

Shareholders and their role in equity markets
3. What are the implications of the changing nature of UK share ownership for corporate governance and equity markets?

The headline figures on share-ownership produced by the Office for National Statistics (ONS) demonstrate a long-term decline in the proportion of UK equities held by domestic institutional investors including pension funds.[1] This reflects asset allocation decisions resulting from both a desire for diversification (many funds have increased their overseas equity holdings while reducing UK exposure) and increasing maturity of schemes. Over the same period there has been a significant increase in the proportion of UK equities held by overseas investors.

In theory this means that the potential influence of domestic institutions is significantly lessened. But whilst this is true to some extent, we should be aware of countervailing factors. Voting turnout at company meetings is typically in the region of 50% to 60%, and the overwhelming majority of UK institutions exercise their votes, while this may not be the case for overseas investors. As such, domestic institutions may have proportionately more voting power.

In addition the ONS statistics set out domestic ownership of UK equities at the aggregate level. At the company level it is not uncommon to find domestic institutions taking significant active positions in individual companies. For example, in February 2010 the property company Grainger lost the vote on its remuneration report.[2] Disclosed holdings in the company reveal that the three largest holders were as follows:

Schroder Investment Management	- 16.88%
BlackRock Investment Management	- 10.17%
Standard Life Investments	- 6.93%

The voting turnout at the AGM was approximately 71%, meaning that these three institutions alone accounted for just under 48.5% of votes cast. Given this potential power, just one of these managers could surely influence board thinking.

4. What are the most effective forms of engagement?

This will depend to a significant degree on the issues concerned, the context and the attitude of the company involved. On some issues – such as pay – the use of shareholder voting rights can bring about change, although it is arguable that investors could have used these rights more effectively in the recent past. It is also important that companies are made aware of why shareholders reach certain voting decisions. Therefore companies on the Forum's Global Focus List are always informed of both why the Forum has chosen to engage with them and, following engagement if relevant, the reasons for any votes against.

In LAPFF's experience, meeting with company representatives in person is crucial in bringing about change. Communicating by letter, email or phone can convey certain information but nuances are lost. Therefore the Forum seeks face-to-face meetings with companies where it has particular interests or concerns.

Where companies fail to respond or do not adequately address governance or other investment concerns a more direct approach might be required. For example the Forum has filed a number of shareholder resolutions over the years, most recently at

[1] http://www.statistics.gov.uk/pdfdir/share0110.pdf
[2] http://www.investegate.co.uk/Article.aspx?id=201002101701589793G

Marks & Spencer in 2009, where other forms of engagement have proved ineffective. The advantage of shareholder resolutions is that they can be focused on specific issues, and represent an escalation of engagement where the company does not address investor concerns substantively.

However the number of shareholder resolutions filed in the UK is small. This may be in part because of the complexities of the filing process and the threshold of share ownership required. The current requirements are of either 5% or 100 shareholders with an average of a £100 holding each. The latter arguably can actually make filing resolutions more attractive to campaign groups by mobilising supporters to buy shares, rather than enabling concerned institutional investors to escalate concerns to the AGM agenda. Shareholder engagement could be strengthened by making it easier for institutional investors to file resolutions.

This proposal was included in the initial draft of the Institutional Shareholders Committee (ISC) paper on the financial crisis which stated: "The ISC believes it would assist investors if it were made easier for them to table non-binding resolutions at a lower threshold of ownership than applies to binding resolutions."[3]

The proposal was inexplicably dropped from the final paper, but this may be an option that the Government wishes to explore.

5. Is there sufficient dialogue within investment firms between managers with different functions (such as corporate governance and investment teams)?

In LAPFF's experience there can sometimes be insufficient dialogue between these two functions. For example, in our engagement with Marks & Spencer from 2008 onwards, the Forum spent considerable time talking to investment institutions. In the case of one asset manager with a large active position we gained the impression that the portfolio manager had little interest in corporate governance. Having taken a large position they were going to support the company come what may, despite a major breach of governance best practice which was widely criticised. We do not believe the corporate governance officer shared this view.

Clearly governance concerns are not always material, and there are different ways to address them in any case. Nonetheless, the Forum does not consider that recent history has seen the governance function within asset managers in particular given sufficient weight either in presenting a consistent view on an issue or in determining voting positions.

6. How important is voting as a form of engagement? What are the benefits and costs of institutional shareholders and fund managers disclosing publicly how they have voted?

We note that the ISC, which brings together a number of investment trade bodies, emphasised the importance of utilising voting rights in its 2009 paper on the role of institutional investors:

---

[3] Initial draft of the ISC paper seen by LAPFF

"Where… dialogue fails to produce an appropriate response, shareholders and/or their agents should be prepared to use the full range of their powers including voting against resolutions and follow-up afterwards. The ISC considers that investors have on occasion been too reluctant to act in this way."[4]

The Forum believes that voting is a core element of engagement; importantly it has legal power and is quantifiable. Ultimately voting is most effective when embedded within a broader engagement process.

LAPFF supports the public disclosure of full shareholder voting records. As we noted in an internal LAPFF paper published in 2009 which reviewed asset manager voting: "Given the apparent failures of institutional shareholders to engage effectively with banks in the run-up to the financial crisis, there is now surely a compelling public interest argument in favour of a mandatory disclosure regime."

The benefit of full disclosure is that it would facilitate the analysis of how various investors exercise their ownership rights. With the patchy reporting under the current voluntary regime this is simply not possible. LAPFF considers that the costs of making voting data public are negligible.

7. Is short-termism in equity markets a problem and, if so, how should it be addressed?

It is not clear what is meant by 'short-termism' in this case. If there has been a decrease in average holding period for equities, this is a potential problem for investors if the trading costs incurred outweigh the benefits, but it is not clear what responsibility the Government has for poor investment decision-making. The challenge is for trustees and other asset manager clients to review their investment mandates and design more effective arrangements if needed.

It may be the case that shorter holding periods result in greater short-term pressure on boards, but LAPFF is not aware of any research establishing this. If such a link is established then the Government could give consideration to incentivising long-term holdings. Alternatively companies themselves could address this through dividend policy, for example by paying a slightly higher dividend to long-term holders.

8. What action, if any, should be taken to encourage a long-term focus in UK equity investment decisions? What are the benefits and costs of possible actions to encourage longer holding periods?

The benefits of longer holding periods potentially accrue to two different groups – companies and investors. The theoretical benefit to companies is presumably that longer holding periods would see them subject to less short-term pressure, though clearly evidence would need to be provided that this is indeed the case.

For investors the theoretical benefit of longer holding periods is that this would reduce their costs. Again evidence would need to be provided here, as it may be the case that

[4] http://institutionalshareholderscommittee.org.uk/sitebuildercontent/sitebuilderfiles/ISCImprovingInstitutionalInvestorsRoleInGovernance050609.pdf

the benefits of trading outweigh the costs. We note the comments of Watson Wyatt when it explored this question a number of years ago that for pension funds as a whole, an increase in trading is an increase in costs.[5] It suggested that long-term (ie ten year) mandates were one potential solution.

9. Are there agency problems in the investment chain and, if so, how should they be addressed?

There are clearly agency relationships at various points in the investment chain, not just in the investor-company relationship, but also in the asset manager-client relationship. However whether these are agency ‘problems’ is a different question.

It is possible that the principal issue to be resolved is clarity in the expectations of those on each side of the relationship. Investors should be clear what their time horizons are, so that boards can assess whether and how they can relate to them. In this process it should be clear that investors’ interests will vary dramatically, so boards need to have the freedom to balance these. Similarly the clients of asset managers should be clear about their investment time horizons, so that managers have a clear idea of how long they have to see an investment decision play out.

It may be the case that both boards and asset managers are misinterpreting the expectations of their principals, leading to the assumption of short-term pressure where it may not actually exist. It is notable that previous studies of short-termism have suggested this.[6] Greater clarity about actual expectations may therefore mitigate such (potentially self-imposed) pressure.

10. What would be the benefits and costs of more transparency in the role of fund managers, their mandates and their pay?

The theoretical benefits of greater transparency are presumably that this would enable trustees and others to identify potentially problematic arrangements. However, it is not clear that it is the nature of these arrangements which is responsible for short-termism in equity markets. If asset managers, for example, do feel (rightly or wrongly) they are under short-term pressure from their clients, this seems likely to persist regardless of the nature of their remuneration.

In any event, trustees can surely construct investment mandates in any way they choose, including the way in which the manager is rewarded, regardless of how such arrangements are reported.

Directors’ Remuneration

11. What are the main reasons for the increase in directors’ remuneration? Are these appropriate?

There are likely to be numerous factors at play. Clearly, to some extent, supply and demand determines the ‘cost’ of executive talent, though there may be a debate over whether boards favour buying in external talent over developing internal candidates.

5 “[Increased UK equity turnover] has enriched the broking community and impoverished the *average* pension fund.”, *Remapping Our Investment World*, Watson Wyatt, 2003

6 *NAPF/IMA Short-termism Study Report*, September 2004

The peer group comparison no doubt also plays a significant part. Boards do not want to pay 'below average', perhaps in part because this might suggest that their executives are qualitatively also below average. This pressure is probably exacerbated by the use of remuneration consultants who frequently use peer group benchmarks.

The constituent members of remuneration committees may also be a contributory factor. Most committee members are also directors of other companies, and are therefore accustomed to high pay. They seem unlikely to exert downward pressure on rewards because they themselves are part of the high pay culture.

Finally, there appears to be no notion of restraint in most boardrooms, and this may in part result from the nature of the company-shareholder relationship. Boards largely pay directors what they wish, with shareholder pressure on them to exercise restraint being a minimal countervailing force. Defeats at company AGMs over remuneration issues are very rare, and the average level of shareholder opposition to remuneration-related resolutions is notably very low.

12. What would be the effect of widening the membership of the remuneration committee on directors' remuneration?

This will depend on who the new members of remuneration committees are. The two groups that have been mentioned in commentary on this issue are shareholder representatives and employee representatives. The former group are likely to have significantly more technical knowledge; the latter seem more likely to exert pressure to consider employee pay when setting remuneration policy. However these assertions are speculative, and therefore it may be worth the Government exploring this issue in more detail.

LAPFF has no objection to widening the membership of remuneration committees in principle, provided that this does not conflict with the need for an appropriate level of independent representation on them.

13. Are shareholders effective in holding companies to account over pay? Are there further areas of pay, such as golden parachutes, it would be beneficial to subject to shareholder approval?

Anecdotal evidence suggests that there is a significant amount of engagement between investors and companies over pay, and indeed the Forum is often involved in this itself. However it is clear that the level of opposition to remuneration-related resolutions is, in general, low. LAPFF's own analysis of voting by asset managers carried out in 2009 suggested that a number had rarely voted against management over pay, or indeed any other issues, at the UK's banks.

It is not clear whether this lack of opposition is because investors are not effective at engagement, or simply because they are content with the remuneration policies in place. It would require further analysis to establish why shareholders vote the way they do, and we would encourage the Government to undertake this.

14. What would be the impact of greater transparency of directors' pay in respect of linkage between pay and meeting corporate objectives, performance criteria for annual bonus schemes, relationship between directors' pay and employees' pay?

The Forum believes that there would be benefit in greater transparency in this area, particularly on the relationship between board and employee pay. In LAPFF's public statement on the financial crisis we argued that "For too long, continually rising executive remuneration, and the widening gap between directors and other employees, has been treated as… somehow inevitable and therefore un-problematic…"[7]

Providing shareholders with more information in this area would at least enable them to take a view on the level of reward in context. In addition the Forum has, with the NAPF, called for greater transparency in relation to directors' pensions, where again there is often a significant divergence between boardroom provision and that for other employees in the same company.[8]

Finally, the Forum also encourages companies to provide greater information on the link, if any, between management of non-financial factors and remuneration. For example, the Forum met with BP in 2006 to persude the company to link remuneration with non-financial metrics, in particular as the core driver of health and safety, and had continued to engage with the company on this issue. Indeed promoting non-financial business factors as a key element of structuring remuneration has been an integral part of Forum research and engagement over the past four years.

Takeovers

15. Do boards understand the long-term implications of takeovers, and communicate the long-term implications of bids effectively?

The Forum published a trustee guide on mergers and acquisitions in 2007 because it was felt that shareholders were not successful in ensuring that deals that took place were in shareholders' long-term interest.[9] It is impossible to comment about the understanding of boards in general, but it does appear that in individual cases some boards are not effective in their corporate M&A activity. As recent cases, such as the RBS acquisition of ABN Amro, demonstrate, it is dangerous for shareholders to assume that boards are reaching optimal decisions in respect of M&A activity.

16. Should the shareholders of an acquiring company in all cases be invited to vote on takeover bids, and what would be the benefits and costs of this?

The Forum is not opposed to this proposal in principle, and clearly this already occurs in certain cases. Extending the requirement for a vote to all bids would incur costs in respect of meetings and associated documentation. Nonetheless it would provide an outlet for possible concerns, in addition it would enable shareholders themselves to be held accountable, providing that they are required to disclose their voting decision.

[7] http://www.lapfforum.org/pubs/press_releases/LAPFF_crisis_statement_May_09.pdf
[8] http://www.lapfforum.org/node/62
[9] http://www.lapfforum.org/pubs/trustee_guides/LAPFF%20Trustee%20Guide%20Which%20deals%20create%20value%202007.pdf

Other

17. Do you have any further comments on issues related to this consultation?

The Forum would strongly encourage the Government to undertake its own research before advancing specific policy proposals.