NAPF
Securing the future of pensions

Department for Business, Innovation & Skills: A long-term focus for corporate Britain

Call for evidence

A response by the National Association of Pension Funds

January 2011

Contents

About the National Association of Pension Funds **3**
Answers to consultation questions **3**
The Board of Directors 3
Shareholders and their role in equity markets 4
Directors' remuneration 8
Takeovers 10
Other 11
Appendix **12**

NAPF
Securing the future of pensions

About the National Association of Pension Funds

The National Association of Pension Funds (NAPF) is grateful for the opportunity to respond to the Department for Business, Innovation and Skills' Call for Evidence, *a long-term focus for corporate Britain*.

The NAPF is the UK's leading voice for workplace pensions. We represent all types of workplace pension scheme, including defined benefit, defined contribution, group personal pensions and statutory schemes such as those in local government. Between them, our members have combined assets of approximately £700 billion, and operate some 1,200 pension schemes. Our membership also includes over 400 providers of essential advice and services to the pensions sector. This includes accounting firms, solicitors, fund managers, consultants and actuaries.

Answers to consultation questions

The Board of Directors

1. **Do UK boards have a long-term focus? If not, why not?**

   Companies typically have a long-term focus, and so in theory the boards overseeing companies should also have a long-term focus. We agree however that boards often appear to be unduly influenced by short-term share price expectations and movements. Short-term share price performance can of course be determined by factors that are beyond the company's control (the collapse of Lehman Brothers, for example).

   While boards need to listen and react to the views of investors, they should actively promote the business as being long-term. They can do this by explaining their strategic objectives, what they are doing to achieve their objectives, and how their actions align with stakeholders and their long-term expectations.

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?**

   The Companies Act 2006 states that boards of public companies may, at their discretion, require shareholders to provide information about themselves. Companies increasingly choose to exercise this right, particularly as it is a means of enhancing investor relations. There is a suggestion in the Call for Evidence that better overall transparency could be achieved if this information were required by all investors, and not only at the discretion of the company.

   Three particular developments have made it more difficult for companies to build a clear picture of their share register: the use of nominee accounts; the growing internationalisation of institutional investment; and the increase in stock lending activity. In addition pension funds are making increasing use of pooled funds which can provide an efficient and cost-effective way of accessing investment markets. Their underlying ownership positions are therefore not apparent to companies. Whilst the NAPF believes that companies should have ready access to the beneficial

owners of their shares, there are issues which would complicate a system that obliges all shareholders to disclose information on themselves. For example, stock lending presents real difficulties because, while title passes to the borrower, the lender retains the economic interest in the business. Lenders are particularly exposed during a takeover as the right to vote passes to the borrower. This is a complex area but one which merits further analysis and where there may well be an opportunity to introduce reforms which are in the interest of the longer term investor.

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?

Technological advances and globalisation have lead to many changes in the way financial markets operate on both a local and global scale. Investors now have access to a much greater range of investment products, which has resulted in a greater variety of trading and investment styles.

Some of the effects of this market evolution include a broader range of investment drivers; a global spread of market participants; an increase in foreign listings in the UK equities market; and greater access to alternative asset classes with a greater range of investment time horizons.

Pension funds are making increasing use of these different asset classes and investment styles, but the bulk of their assets remain invested in conventional bonds and equities which are held over the medium to longer term.

One particular area of interest is the role of the proxy voting agencies. The expansion of investments into global markets has resulted in an increased reliance on the services of proxy voting agencies. This is especially the case among under-resourced investors who require information on companies in the domestic market as well as global markets, yet do not have the resources to undertake the research, engagement and voting themselves. This reliance has given a perceived 'power' to the voting agencies in determining the way investors vote on resolutions. An analysis of voting at UK company meetings suggests that their influence can be exaggerated as there is no strong correlation between their recommendations and voting outcomes.

4. What are the most effective forms of engagement?

Typically, NAPF members as investors buy shares in companies because they like the company, its strategy, and its potential for delivering investment returns. Investors generally engage with investee companies as a means of monitoring practices and performance in line with strategic direction and expectations. This is as distinct from activist investors, who invest in companies with the sole purpose of bringing about change. Our response refers to the former.

There are a number of forms of engagement, both direct and indirect, typically including face to face, exercising of voting rights and written communications. We consider that the best engagement is constructive and confidential, and it is most effective when it is undertaken well in advance of a problem or issue arising. Reactive engagement is far less effective from both an

investor and company perspective, as it tends to address specific problems, rather than the underlying objectives and strategies. The power of the shareholder vote on resolutions should not be underestimated as an effective form of highlighting areas of concern, however we would point out that this is most effective when coupled with direct engagement with the company.

The 'effectiveness' of engagement is often difficult to measure, particularly in many cases where engagement is part of the routine and ongoing monitoring of the company. To this end, it is not expected that all engagement will be an obvious and direct catalyst for change. Good companies will take engagement on board and will react positively to ongoing consultation, yet the results of such may not be immediately apparent. We consider that a good indicator of effective engagement is a free flow of information from both the company and shareholders, thus promoting good, candid discussions.

It should be noted that discussions between companies and investors are not always immediately apparent to the outsider. We believe the confidential nature of quality engagement is normally beneficial to both the company and the investor, and publicity around such discussions can be to the detriment of the desired outcomes. We would therefore discourage any requirement for mandatory disclosure of meetings held.

Collaborative engagement can also be effective. However there are barriers to effective collaborative engagement, such as competition, confidentiality, investment drivers and styles, and logistics. Where collaborative engagement is achieved, it is a powerful means of sending a strong message to the company and can be an effective catalyst for change.

5. **Is there sufficient dialogue within investment firms between managers with different functions (i.e. corporate governance and investment teams)?**
   Whilst we are not in a position to answer this question directly, we would encourage extensive dialogue between functions within investment firms. We also encourage firms to integrate the functions where possible.

   Pension funds when reviewing their managers' application of the Stewardship Code are likely to see that analysis as an extension of a review of investment policy, process and performance, thus reinforcing the integration of decision making across the investment team.

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 believe that voting as a form of engagement and ongoing monitoring of the company is extremely important and effective, but only when it is coupled with direct engagement with the company. A vote without engagement or explanation is somewhat meaningless to a company. We are not supportive of compulsory shareholder voting, however, as this may lead to voting being treated more as a compliance exercise, thus detracting from the effectiveness of the vote as a catalyst for change.

We are also concerned about potential moves towards mandatory public disclosure of voting records. There is a legitimate cost associated with disclosing votes, and this may result in a diversion of scarce resources within the investor organisation. We also question whether there is in fact a wide public interest in having voting records publicly disclosed. We do, however, see the benefits in making voting records available to pension fund clients as part of the investment report.

It is important that any disclosed voting information is seen in the context of engagement with the company, and this can often be difficult given the confidential nature of most engagement dialogue. There is a risk that potential users of disclosed voting data may not view it in context and it could therefore be inconsequential.

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

One of the first things to determine when considering this question is how to define short- and long-term. The Call for Evidence defines short-termism as "the focus of investors and managers on short-term returns at the expense of those over the longer-term". This definition can be differently applied to investors and company managers. We would question whether investors focus on shorter-term returns *at the expense* of longer-term results. Rather, their investment drivers and strategies might favour shorter-term investments and so this is where the focus lies. This may not be to the detriment of longer-term performance. For companies, a focus on short-term factors is much more likely to detract from its longer-term performance. In this context, it is important that companies explain to the market how they are performing against their strategic objectives. This way, investors can more easily evaluate the longer-term underlying opportunities and risks facing the business. The trouble often lies in striking the right balance of disclosure, as companies can be reluctant to disclose unfavourable information. Good quality narrative reporting can help to ensure that performance is communicated in the context of strategic objectives, and that stakeholder expectations are managed.

Secondly, one needs to consider the extent to which short-termism is a problem for investors and companies. Short-termism in equity markets leads to an increased turnover of assets, thus allowing for easier and cheaper trading and greater liquidity. This increase of activity in equity markets does not necessarily detract from what the true long-term investor is trying to achieve.

We note that the Call for Evidence highlights the principle-agent problem, and we agree that short-termism in equity markets can have a negative effect on that relationship. A focus on share price performance and short-term results should be a concern when setting executive remuneration, particularly with respect to bonuses paid to executives. It must be noted that the board is responsible for setting executive pay and, in the UK, the board typically comprises a majority of independent, non-executive directors. Therefore, responsibility for awards paid to executives lies with the board as a whole.

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?

Different investors have different objectives, time horizons and investment styles, and therefore their holding periods will differ greatly. We have not seen material evidence to suggest that long-term investing is better for companies and investors and therefore we question whether it is necessary to incentivise shareholders to encourage longer holding periods. Long-term holdings would certainly be better if the cost of more frequent transacting outweighed the rate of return, and we have not seen this to be the case.

If incentives were considered necessary, we do not believe that additional voting rights should be afforded to longer-term shareholders. This may result in entrenchment of the shareholder base to the detriment of the company's long-term performance. More evidence is required to prove that mechanisms such as this do not distort capital allocation and do in fact encourage long-term behaviour across the market, rather than focusing on a limited number of shareholders. We believe it would be better to incentivise shareholders through some form of enhanced dividend scheme.

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

We believe there are agency challenges in the investment chain, however the pensions industry has focussed hard over the past decade on improving governance practices (see the NAPF Report "Institutional Investment Six Years on"; an update of the Myners Review of 2001) and with transparency of reporting and monitoring, these are being addressed.

Agency problems arise where there are potential and real conflicts of interest, which can be broad and often complex. Pension funds trustees are required to disclose any conflicts at each trustee meeting, but what has perhaps received less attention is the inherent conflict in any agency relationship. The investment chain for pension funds is described in detail in our appendix to this submission.

At the interface between companies and their shareholders one area of concern is the length and complexity of the voting chain which can involve several agents who are not always incentivised to ensure that votes are correctly processed. Studies have shown that votes are frequently "lost" potentially with significant implications for the future of a company.

While improved dealing compliance standards have ensured equitable treatment for asset management clients when trades are executed on their behalf, we question whether the same standards apply to corporate governance issues. For example, different investment objectives and timeframes should from time to time give rise to different voting decisions. Particular stress can arise in a takeover where an investor holds shares in both the acquirer and the target company.

Aligning the commercial interests of investment managers with the fundamental interests of investors is complex. The NAPF questions if this could be done to the satisfaction of all market participants, but notes that there are arguments for reviewing investment manager fee structures to ensure an improved alignment with the client's interests.

It is very unusual, in the UK at least, for investment managers to benefit financially from higher portfolio turnover. Any evidence of such practices would be a matter of considerable concern to pension funds. That said, it is more common for investment managers to be insufficiently sensitive to trading costs and their impact on investment returns.

We should also point out that the Stewardship Code, which came into effect in late-2010, deals with conflicts of interest. The Code needs time to bed down, but we are confident that it will go some way to addressing agency problems.

10. **What would be the benefits and costs of more transparency in the role of fund managers, their mandates and their pay?**
With regard to public disclosure, fund managers typically operate to discrete mandates, meaning that their investment objectives and fees will be unique to that client. Additionally, each product offered by a manager may well have a slightly different remuneration arrangement depending on the nature of the investment strategy (e.g. hedge fund vs index fund), so a firm-level disclosure would be meaningless. In any case, managers would not agree that these details should be made available to the wider public (including competitors), except where they manage a public fund, as this is not in their commercial interests and may in fact create additional administrative burdens. As such, we do not see the need for greater public transparency on these matters. In negotiating an investment management contract, pension funds expect full disclosure of the mandate and all revenues earned by the manager as a result. Broader questions are often asked about pay policy at the asset manager to check that it is consistent with the mandate.

The structures of individual remuneration which are considered acceptable are covered under the FSA rules, and this therefore falls under their remit.

Directors' remuneration

11. **What are the main reasons for the increase in directors' remuneration? Are these appropriate?**
There are a number of reasons for the increase in directors' remuneration. Among some of the most common are:

Benchmarking: many companies use peer benchmarking to set their incentive rates, and this can result in regular increases in both base and incentive payments. The NAPF opposes the use of peer benchmarking, unless it is applied infrequently and then only as a singular part of the committee's overall assessment of remuneration policy.

Competition (domestic and global): in order to attract and retain the best executives (from both a domestic and international talent pool) companies often propose that incentive packages need to be better aligned with those of their competitors. As has been highlighted in the Call for Evidence, executive pay in the UK tends to be lower than in the US, and this leads to companies looking to better align their remuneration schemes with their international counterparts.

The guidance on remuneration in the NAPF Corporate Governance Policy and Voting Guidelines follows that of the UK Corporate Governance Code, whereby:

> *Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose. A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance.*
>
> *There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration.*

The Principles of the Code are clear and yet remuneration remains one of the key points of dispute between boards and shareholders. This is primarily due to the absence of demonstrable links between strategy, performance and pay, coupled to the multi-year trend of executive remuneration rising at a faster rate than pay more generally and, in recent times at least, poor returns to shareholders, as measured by share prices and dividends. Many investors are also concerned that remuneration has become too complex and question its effectiveness in motivating management.

The NAPF Policy states that remuneration practices most likely to be of concern to shareholders are:

- Increases in base salary in excess of inflation;
- Over frequent re-benchmarking (we suggest 3 – 5 year intervals);
- Insufficiently demanding performance targets;
- Guaranteed, pensionable or discretionary annual bonuses;
- Insufficient disclosure on the scope of annual bonuses and performance conditions (retrospective disclosure is acceptable);
- Any provision for re-testing of performance conditions;
- Ex-gratia and other non-contractual payments;
- Change in control provisions triggering earlier and/or larger payments and rewards;
- The absence of service contracts for executive directors; and
- Unwarranted use of discretion.

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

We see few benefits from widening the membership of the remuneration committee to include either representatives from outside the company board or remuneration experts. Such a structure might dilute the cohesion of the board which ultimately will decide on remuneration.

We do see arguments for reviewing the committee's effectiveness in the same way as the board as a whole is reviewed.

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

We acknowledge that executive pay has increased at a faster rate than the average for many years, and that many companies do not demonstrate an alignment between remuneration and strategic performance. However, the achievements of shareholders with respect to executive pay in the UK should not be ignored. For example, companies are now required to disclose executives' performance pay; the rolling re-testing of performance targets has been abolished; and directors' contracts seldom contain notice periods in excess of twelve months.

There is scope to enhance shareholders' effectiveness in holding companies to account over pay. The guidance published by the ABI on remuneration structures, by the NAPF/ABI on termination payments (which is designed to eliminate 'payments for failure') and by the NAPF/LAPFF on pensions disclosure should all be taken into account by shareholders when assessing remuneration policy.

We believe the non-binding vote on remuneration is of benefit to investors and companies in setting remuneration policy. When coupled with effective engagement, shareholders are able to send a strong message to the board, yet without compromising the board's discretion on executive pay. We hold the view that boards are in the best position to align remuneration schemes with the company's performance against its strategies and targets, and shareholders are best positioned to monitor this with a view to ensuring the discretion granted is not taken advantage of.

14. What would be the impact of greater transparency of directors' pay in respect of:

a. Linkage between pay and meeting corporate objectives;

b. Performance criteria for annual bonus schemes; and

c. Relationship between directors' pay and employees' pay?

We believe that greater disclosure around each of these factors would be of benefit to companies and shareholders. Transparency of remuneration policy will enable shareholders to better understand the company, thus assisting them to make well informed investment decisions. It is also important that companies disclose the information in a way which is clear. Many shareholders are concerned that remuneration policies are too complex and that the symmetry between remuneration, shareholder returns and the long-term objectives of the company is lost.

Takeovers

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

We are not in a position to comment on companies' understanding of the long-term implications of takeovers. We hope that companies will respond to this question and will be interested in the insights provided.

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?

Yes, the NAPF believes that shareholders of an acquiring company should be invited to vote on takeover bids. Shareholders should be given the opportunity to confirm their support (or otherwise) for the proposed use of their capital, and the ability to vote on takeover bids enables shareholders to bring an acquisition to an end where there is insufficient support.

Other

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

See the description of the investment governance chain set out below.

Contact:

Emily Dellios
Policy Adviser Corporate Governance & Investment

David Paterson
Head of Corporate Governance

Appendix

The Investment Governance Chain

1. Trustees are responsible for setting investment policy, under advice from an investment consultant (whom they will select, often with the involvement of the sponsor).
2. For DB schemes this means establishing asset allocation and selecting suitable managers, if they have outsourced investment management, as most do. The frequency of reviewing the asset allocation will vary considerably across UK schemes, but will be at least every three years, as a consequence of the actuarial valuation. Manager performance is monitored quarterly in most cases with formal manager meetings and reviews taking place at least annually. While manager appointments can be terminated at any time, most will last for at least three to five years. The standard contract (Investment Management Agreement) used was drawn up by the IMA several years ago.
3. The investment consultants have a key role to play in providing advice on asset allocation and on manager selection and on-going monitoring. They are typically paid on a time not performance basis. The industry has undergone a recent period of merger and consolidation and is dominated by 3 big consultancies: Towers Watson, Mercer and Aon Hewitt. There are many smaller firms who provide advice, some of it highly specialised (eg private equity or liability driven strategies). Most firms provide both actuarial and investment advisory services and it is not unusual to employ the same firm to do both.
4. In providing investment advice, consultants will set out the investment process employed by an asset manager including, since the introduction of the Code, their approach to Stewardship. Given the necessary focus on financial returns (particularly historic ones) trustees and their advisers have found it difficult to capture the link between investment process (including Stewardship) and future returns.
5. Under the requirements of the SRI Pensions Disclosure Regulations (2000), trustees are required to disclose how, if at all, they address social, environmental and ethical issues in their investment policy. Most trustees have delegated this responsibility to their investment managers. It is fair to say that many have not reviewed their managers' compliance with the agreed policy as formally as they should have. This may now change following the introduction of the Stewardship Code. Although it addresses different issues, there is a strong link between the two which is hard to ignore.
6. Most trustees when appointing an investment manager will adopt (either formally or informally) the voting policies followed by that manager, most of whom in turn take advice from one of the proxy voting agencies. For UK equities these generally follow the requirements of the UK Corporate Governance Code. The 'comply or explain' regime inevitably results in a range of voting responses and it is unusual for management-supported resolutions to be defeated at an AGM.
7. Formal and detailed review of voting activity remains rare outside the largest funds. Likewise publication of detailed voting activity is uncommon.

8. Trustees are also responsible for the selection of funds in trust-based DC schemes. As above they will take advice from a consultant and use the consultant to perform ongoing monitoring of performance and the manager(s).

9. As DC uses pooled funds exclusively the corporate governance policies will be set by the investment manager and there is unlikely to be any input from the trustees.

10. Pooled funds are also the vehicles of choice for many investment strategies as they offer flexibility and simplicity as well as the benefits of economies of scale. We are not aware of any pension funds who have gone down the route of using the customised ("wrap") accounts which have become increasingly popular with individual investors.

11. Pooled funds have two governance drawbacks: it is close to impossible to set a client-specific voting policy; and the funds themselves, being frequently held through insurance policies, are not required to hold open investor meetings at which management can be held to account by unit holders or investors.

12. A further issue for pooled fund investors is stock lending where policy is set by the investment manager, who normally shares in the revenues, but all of the risk is carried by the end-client. Where stock is lent the vote is lost despite the retention of an economic interest. From time to time this vote can be crucial to the future of the business (eg in a takeover).