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PLSA Response: Law Commission call for evidence on Intermediated securities

The PLSA is the voice for pensions and lifetime savings in the UK, representing over 1,300 pension schemes with just over £1 trillion in assets under management and over 400 supporting businesses – including asset managers, investment consultants and other service providers. Our purpose is to help everyone achieve a better income in retirement.

Introduction

The PLSA¹ has long noted that while the nature of intermediated relationships in the UK investment chain has a number of practical and administrative benefits, it also presents potential legal barriers to schemes' ability to exercise their shareholder rights. We had also previously called for the Law Commission to express a view as to whether there are legal barriers preventing the directing of voting by pension funds within pooled funds.

We therefore support the Law Commission's scoping study of the intermediated securities system. We hope it will be the first step in a broader programme of work from the industry and the Government to address issues in the system and ultimately help institutional investors act as good stewards of their assets.

In forming our response, we have spoken to a wide range of members including asset owners, asset managers and lawyers to gain a clear and balanced view of the concerns surrounding intermediated securities and the effective exercise of shareholder rights from across the voting chain.

Pension schemes have a duty to act as good stewards of scheme members' assets, investing in a way which will achieve better outcomes for scheme beneficiaries. Pension schemes also have a unique role to play in drawing up good stewardship practices through the investment chain. Our members believe stewardship is important, with 71% of scheme respondents to the PLSA's 2017 Stewardship survey² stating that they take stewardship factors into consideration when

¹ Including in its former guise as the National Association of Pension Funds (NAPF)

² PLSA 2017 Stewardship Survey.

selecting their asset manager, and 76% saying that environmental, social and governance (ESG) considerations are financially material to their investments.

Recent changes to regulation³ mean that schemes have new requirements and are under increased scrutiny in terms of how they behave – and communicate how they are behaving – as good stewards of their assets. Effectively exercising voting rights is an important part of good stewardship, with investors having a key role to play in wielding influence as owners to promote the long-term success of the companies they invest in. Given the highly-intermediated nature of the investment chain in the UK, it is important for schemes to work effectively with their advisers and managers to monitor, engage with and ultimately ensure the board and management of the companies they invest in are held accountable to shareholders.

We agree that there are several barriers to ensuring that scheme investors can exercise their ownership rights effectively, from their ability to cast votes in pooled funds to concerns around a lack of transparency which then impacts effective take-up of, and participation in, collaborative engagement initiatives. It is also clear that some larger funds are better able to use their voice in terms of being able to wield greater negotiating power and invest in segregated – not pooled – accounts. It is therefore particularly important for less well-resourced schemes that any existing legal, technical or operational barriers which exist are overcome.

We think it is important at this stage to clarify expectations regarding the level of resources that smaller schemes will be able to devote to considering how to cast their vote. Pension schemes have to consider a wide array of investment, administration, communications, regulatory, legal and governance issues. Although the majority of schemes recognise the importance of meaningfully casting their vote with their investee companies, reducing the legal and operational barriers to doing so will not be sufficient to support less well-resourced schemes in being effective stewards.

With this in mind, it is vital that policy initiatives to improve the efficiency of voting procedures are separated from any wider intention to place a greater onus on pension funds to demonstrate active stewardship. For instance, it should be sufficient for small funds to explain how they have ensured good stewardship on their behalf and to be able to provide information on their voting record and how they have monitored and overseen the activity of the managers representing them.

We are also optimistic that the recent changes to the Stewardship Code and in particular the more detailed disclosure requirements, including around the purpose of voting, will have a positive impact and support asset owners to better differentiate excellence in their asset

³ Including the 2018 and the 2019 changes to the *Occupational Pension Schemes (Investment) Regulations*.

managers and other service providers on stewardship, including the meaningful engagement and exercise – where relevant – of their vote.

We hope that the government, regulators and other bodies will work with the industry and take a joined-up, coherent approach to supportive effective and proportionate scheme stewardship by all schemes.

Our response below focuses on highlighting specific areas where our members have the greatest concerns instead of answering questions in turn.

Response

The UK investment chain is particularly highly intermediated, with a number of different actors lying between the pension schemes – which have a fiduciary duty to invest in scheme members’ best interests – and the companies they invest in. While there are benefits to the intermediation process, we agree with the Commission that inherent in this system are a number of operational, legal and structural barriers to schemes effectively using their voting rights as part of their broader stewardship approach.

Lack of end-to-end voting confirmation

We agree that manual processes as part of the voting system can act as a barrier to ultimate investors. Our members tell us that there is little an investor can do to confirm whether votes have been correctly counted or processed, which may lead to those investors feeling uncertain about whether their vote has been properly enacted. The lack of end-to-end vote confirmation is a source of frustration for schemes, particularly those which are smaller: while larger schemes are often able to ensure that voting rights are passed back to them, smaller investors do not usually have these arrangements in place with their investment managers (often because they are in pooled accounts).

Under the Shareholder Rights Directive II (SRD II), schemes are required to explain their arrangements with asset managers in their Statement of Investment Principles, including how they incentivise their appointed investment managers to align investment strategy with the trustees’ policies and to make investment decisions based on long-term performance. Therefore, the lack of vote confirmation can have a very real implication for schemes when trying to comply with the new requirements, as they will be unable to demonstrate whether votes have been cast in accordance in a way which aligns with their broader investment and stewardship objectives and principles. It is currently unclear as to whether asset managers will make changes in suitable time to enable this group to readily discharge their duties.

Voting timescales

The consultation asks whether the practical arrangements around the timing of votes can affect the ability of institutional and retail end investors to vote. In the UK, the voting deadlines are typically 3 to 7 days⁴, our members agreed that it can take too long for information to be sent across the entire length of the chain, which could result in scheme investors not having the sufficient time or resources to decide on their position and submit their vote in time.

Another issue may not be the voting deadline for individual company meetings, rather the number of meetings that take place at the same time which limits the amount of time investors have to consider votes. Generally, UK AGMs take place during the months of April to July, therefore, with so many taking place, investors may have little time and resource to consider and engage with each company. It is important that all parts of the financial analysis and research chain work together as efficiently as possible.

Other issues

Any solutions or next steps must work for many different types and sizes of scheme. Even if the relevant legal and operational barriers are identified and overcome, the government and industry must work together to ensure schemes with different governance and stewardship resources are equipped as far as possible to exercise their shareholder rights meaningfully.

The PLSA has previously called for, and taken part in producing guidance on, the need for schemes to better and more clearly outline in their Investment Management Agreement (IMA) and other legal documents the client's expectations of their asset manager with regards to stewardship activities. Although this is primarily of relevance to those schemes with segregated mandates, we think further work needs to be done on supporting schemes to draft their IMAs. We believe that the International Corporate Governance Network (ICGN)'s work in the area of model mandates provides useful insights.

We also think that schemes need further support on understanding the implications of stock lending for their voting approaches. Although the number of pension funds using stock lending in the wake of the financial crisis has declined, and there are some income benefits from this activity as well as advantages for market liquidity, we think there is still some confusion amongst schemes regarding the risks and forfeiture of certain rights. In the new regulatory environment for schemes and their stewardship disclosures, it will be particularly important for schemes to demonstrate they have understood the issue and implications for exercising their voting rights.

⁴ Legal & General Investment Management (June 2019), A guide to the proxy voting chain

Schemes invested in pooled funds

Many pension schemes invest in pooled funds, with 44% of total UK managed assets managed on a pooled basis in 2018⁵. Pooled funds provide smaller pension schemes with the opportunity to gain from economies of scale and can often – though this is not always the case⁶ – be cheaper than segregated funds, which has made them a popular investment choice with schemes and their advisers.

Pension funds rely on asset managers to exercise their votes at company meetings, however, asset managers of pooled funds rarely accept their client's voting preferences. We understand that this can be for a number of reasons on the asset manager's part, including the complexity involved in splitting votes, legal issues or as a matter of principle⁷.

Investors in pooled funds are also likely to be pooled again, at the custodian level, in an omnibus account, adding a further layer of complexity and intermediation. Although we support the principle behind current attempts – such as the Red Line Voting Initiative⁸, which provides voting instructions covering a range of ESG issues – to support schemes in pooled funds to exercise their voting rights, these are only part of the solution.

Possible legal solutions

The Law Commission has asked whether amending part 9 of the Companies Act 2006 to require voting rights be passed back to the ultimate investor would be part of the solution to ensure investors in pooled funds can exercise their voting rights.

We believe that for a minority of institutional investors, this would be helpful. However, we do not believe this would have the impact the Law Commission intends. As expressed directly to the Law Commission in our investor roundtable earlier in November, contained within the scope of the Commission's study, there are different types of pooled accounts, including nominee accounts and collective investments.

Much of the Law Commission's study seems to be focused on nominee accounts, where the legal owner is a nominee company. However, pension funds are more likely to hold assets in collective investment vehicles (pooled funds). Therefore, any proposed legal changes to part 9 of the Companies Act 2006 would not be applicable to many smaller pension fund investors, and would not significantly impact the number of investors being able to vote.

Rather, we believe the focus should be on reducing barriers in the administrative and technological framework for exercising votes in pooled funds, as well as boosting transparency across the investment chain.

⁵ Investment Association (September 2019), Investment Management in the UK 2018-2019

⁶ Chris Sier research (citation needed)

⁷ AMNT review into fund managers' voting policies and practices (May 2019)

⁸ AMNT Red Line Voting Initiative

The need for greater transparency

We believe that initiatives to encourage greater transparency both from fund managers and other participants in the investment chain would be helpful for pension schemes.

Currently, fund managers are not required to publicly disclose their voting policies or guidelines, which can therefore make it difficult for the ultimate investor to ensure that their fund manager's policies are aligned with their own.

It may be appropriate, therefore, for fund managers to be required to publish their voting policies and, as far as possible, publicly disclose their voting records, as set out in and aligned with the FRC Stewardship Code⁹. These actions would allow investors to better assess whether the manager fully represents their views and hold them to account for their decisions.

Ensuring better disclosure on voting policies (including intentions, rationale, activities) would also be beneficial for investors in pooled funds – including those which do not have the resources to intercede directly in the voting process. These investors will then be able to have an influence on the quality of the stewardship of assets they oversee on behalf of beneficiaries by only selecting managers who provide strong stewardship on their behalf. In the event that the manager does not represent their views, an investor will be able to deselect them, increasing the incentive for managers to practice good stewardship.

There is also a lack of transparency from CREST with regards to who owns ultimate shares and no formal process for scheme investors to discover who the other large investors in a company are. This makes collective engagement¹⁰ – a powerful tool for effecting change – and putting forward shareholder resolutions much more difficult.

Possible technological solutions

Currently, fund managers must split votes manually if they want to express different views on behalf of different investors. This can prove costly in terms of time and resources, whilst also resulting in execution risk. The technological infrastructure for the voting system needs investment to end this need for manual work when splitting votes but given the levels of capital and assets involved, this should not be an insuperable barrier to overcome.

We also think that there is potential for technological developments, such as distributed ledger technology, to reduce the complexity of the intermediary system, and if correctly implemented, could be used to improve transparency and strengthen the rights of ultimate investors.

⁹ FRC, The UK Stewardship Code 2020

¹⁰ The PLSA believes that collective engagement activities are vital for investors to signal to companies those concerns which are widely shared by the shareholder base and particularly a particularly important approach for smaller investors to maximise their influence. We believe that by working collectively, institutional investors can engage with companies to improve long-term company performance as well as overall returns.

However, there would need to be strong take up on any technology developed for this purpose in order to achieve effective change. Ensuring the widespread use of such technology, which often makes use of blockchain, could be challenging. The implementation of blockchain technology could require significant changes to regulations to ensure its use would not pose any risks to the market, whilst enhanced security would also be needed to ensure its integrity.

We trust that you will find our response helpful, and will be happy to discuss our positions in further detail if you have any questions.

Yours sincerely,

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