NAPF

Pension Funds' Engagement with Companies - 2006

October 2006

NAPF Research Report 6

Executive summary

Institutional shareholders cannot attempt to micro-manage the companies they own. Nor, however, need their guidance to management be expressed purely through share purchase when in agreement and divestment when not. Instead, responsible shareholders will seek to engage appropriately with the companies in which they invest, for example by addressing concerns before they develop into major problems. This survey, covering 41 of the UK's largest pension funds, is the second review of pension funds' engagement with companies to be published by the NAPF. It demonstrates that large funds are continuing to step up their engagement efforts.

Key results

- **Familiarity with ISC Principles:** Awareness of the ISC Statement of Principles remains high. Nearly nine out of 10 large pension funds are familiar with its content. The most common way of implementing the ISC Principles is to incorporate them into the scheme's own Statement of Investment Principles.
- **Schemes' engagement policies:** Seven out of 10 funds surveyed have their own policy on corporate governance, engagement and/or corporate social responsibility.
- **Corporate governance standards:** None of the funds surveyed believe that overall standards of corporate governance in the UK are deteriorating. 85% believe corporate governance standards are improving.
- **Reports from investment managers:** More than nine out of 10 funds receive regular reports from investment managers on voting. Seven out of 10 receive regular reports on wider engagement issues. Most funds now receive both oral and written reports. In nearly two-thirds of schemes, reports are monitored by an investment committee of the trustee board.
- **Resources devoted to engagement:** Half of the pension funds surveyed have internal resources devoted to shareholder engagement. Half of these funds say these resources have increased since 2004. Nearly two-thirds believe their fund managers devote more resources to engagement now than in 2004.
- **Use of voting reference agencies:** Half of the pension funds surveyed subscribe to at least one voting reference agency. Of these, four out of five have at some stage rejected an agency's recommendation.
- **Stock lending and voting rights:** Three-quarters of schemes either do not lend stock or recall it when they wish to exercise the associated voting rights.

Contents

Shareholder engagement and the ISC Principles

In his 2001 review of institutional investment, Paul Myners found that "concerns about the management and strategy of major companies can persist among analysts and fund managers for long periods before action is taken"[1]. Myners therefore advised that, "managers should routinely consider the possibility of intervening in investee companies as one of the means of adding value for their clients". In addition, "it would be helpful if pension funds themselves recognised the possibility of added value through intervention, and regularly sought evidence from managers to demonstrate that they were active in this way."[2]

When considering how to implement Myners' recommendations, HM Treasury opted for a voluntary approach rather than a prescriptive "tick box" approach grounded in legislation. The Government expects to see progress on a voluntary basis and institutional investors are working to ensure that progress is made.

This survey demonstrates that pension funds are continuing to step up their engagement efforts, and that individual funds are adopting the Myners agenda in ways which best fit with their own circumstances. It suggests, therefore, that the Government is right to favour a voluntary and flexible system.

At the heart of the voluntary approach is the Statement of Principles published by the Institutional Shareholders' Committee (ISC)[3]. The ISC first published a Statement of Principles in 2002. This built on its 1991 statement *The Responsibilities of Institutional Shareholders in the UK* and the 1998 *Combined Code of Corporate Governance*. A revised Statement of Principles was issued in September 2005[4], with a supporting statement from investment consultants published the following month[5]. The ISC is committed to reviewing and, if necessary, refreshing this Statement in 2007 in the light of market experience. In a 2004 consultation document, HM Treasury suggested that pension fund trustees should comply with the ISC Principles[6].

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[1] *Institutional investment in the UK: a review*, HM Treasury, March 2001 (hereafter "Myners Review"), p89

[2] *Myners Review*, p93

[3] The ISC comprises the NAPF, the Investment Management Association, the Association of British Insurers and the Association of Investment Trust Companies

[4] *The responsibilities of institutional shareholders and agents – statement of principles*, ISC, September 2005. See appendix for full text.

[5] *The responsibilities of institutional shareholders and agents – statement of principles: supporting statement from investment consultants*, October 2005. The statement was issued by Hewitt Associates, Hyman Robertson, Mercer Investment Consulting, Russell Investment Group and Watson Wyatt Worldwide.

[6] *Myners principles for institutional investment decision-making: review of progress*, HM Treasury, December 2004, p5

Box 1: The ISC Statement of Principles

The ISC's Statement of Principles sets out best practice for institutional shareholders concerning their responsibilities in respect of the companies in which they invest. It says investors and their agents should:

- set out their policy on how they will discharge their responsibilities – clarifying the priorities attached to particular issues and when they will take action;
- monitor the performance of investee companies and establish a regular dialogue where necessary;
- intervene where necessary;
- evaluate the impact of their engagement; and
- report back to clients/beneficial owners.

Reviewing early progress against the Myners principles, the Government listed the areas where it believed further progress could be made. These included concerns about "insufficient promotion of shareholder engagement"[7].

As well as acting within the ISC, the NAPF has taken a number of initiatives designed to speed up progress by promoting good corporate governance and by equipping pension funds to engage with the companies they invest in.

Box 2: NAPF action on shareholder engagement

- In 2002, the NAPF published separate guides to the Myners principles for trustees of defined benefit schemes and defined contribution schemes. These guides set out the areas in which trustees or fund managers can influence the management of companies, explaining that "trustees are asked to ensure that managers have an explicit strategy that explains when they will intervene in companies."[8]
- In June 2003, NAPF worked with Institutional Shareholder Services (ISS) to establish Research Recommendations Electronic Voting (RREV). As its name implies, RREV provides corporate governance research, as well as voting recommendations and electronic voting services on UK listed stocks. RREV, now solely owned by ISS, uses the NAPF's corporate governance policy. RREV has published a review of voting during the 2005 AGM season. Other RREV research shows that it is now standard practice for companies to consult with shareholders when making significant changes to executive remuneration arrangements.
- In December 2003, the NAPF published revised guidance on corporate governance for pension funds. The principles underpinning this guidance state that: "It is

[7] *Myners principles for institutional decision-making: review of progress*, HM Treasury, December 2004, p2

[8] *The Myners principles: rising to the challenge, NAPF, 2002*, pages 13-15 (defined benefit version) and 18-20 (defined contribution version)

essential that shareholders as owners recognise that they have responsibilities to monitor and normally to support the work of the management of the companies in which they invest. Good corporate governance is about dialogue and the promotion of success. Confrontation is a sign of failure by owners or boards or, sometimes, both"[9].

- In 2003 and 2004, the NAPF revived its Case Committees which facilitate meetings of institutional investors and individual companies where there is concern over either a corporate governance matter or the strategic direction of the company.
- In 2004, the NAPF joined forces with the Investment Management Association to sponsor research into whether pension funds took a long-term view when appointing and reviewing fund managers. The survey found that more than three-quarters of mandates had been in force for at least three years. While reviewing managers regularly, nearly all schemes preferred to measure performance over rolling periods of at least one year[10]. Concerns that managers are judged over time periods too short to permit benefits of engagement to show through therefore appear unfounded.

In 2007, the NAPF will undertake a formal review of the Myners principles on behalf of HM Treasury. In the meantime, this survey indicates that significant advances have been made since 2001, with additional progress made during the past two years.

[9] *2004 Corporate Governance Policy*, NAPF, December 2003, p3
[10] *Short-Termism Study Report*, NAPF/IMA, September 2004

The survey: respondents and methodology

The NAPF sent questionnaires to all pension fund members with assets of at least £1 billion. Responses were received from 41 funds whose combined assets exceed £250 billion – more than one-quarter of all assets in self-administered pension funds[11].

Responses were typically provided by heads of pensions, by individuals responsible for investment, or by the scheme chief executive. Questionnaires were completed between March and June 2006.

For ease of comparison, this report frequently expresses results as percentages. We recognise that this approach may be considered inappropriate for a survey based on a relatively small sample. In many cases, we have therefore indicated the number of respondents providing a specific response as well as the percentage. Not all questions were relevant to every pension fund, so the base for percentage calculations changes between questions.

Comparisons with the first NAPF survey on pension fund engagement are recorded even where the relatively small sample sizes mean that differences between the two sets of findings may not be statistically significant.

At times, the text refers to respondents as "schemes". While this is convenient shorthand, some of the responses to the survey covered more than one pension scheme.

[11] UBS estimate that assets in self-administered pension funds totalled £934 billion at the end of 2005 (*Pension Fund Indicators 2006*, UBS, May 2006, p69)

Pension funds and the ISC Principles

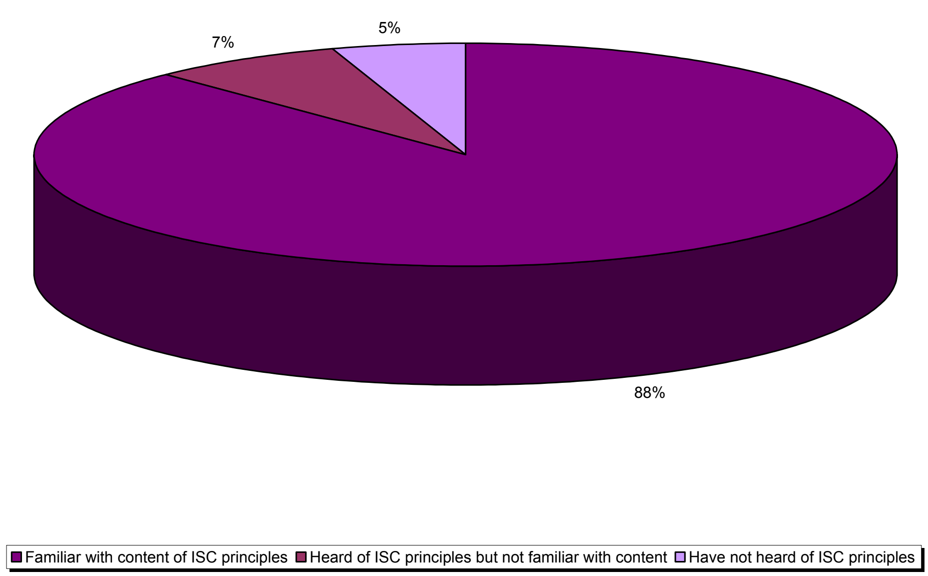
The Government says that "the industry needs to ensure that the ISC Principles have been integrated into investment decision-making and asset management processes"[12]. A substantial majority of the schemes covered by this survey are doing just that. Most have formally integrated the ISC Principles into investment managers' mandates. The remainder are generally pursuing similar objectives through other means.

Pension funds' familiarity with the ISC Principles

Awareness of the ISC Principles is high. Thirty-six out of 41 respondents (88%) are familiar with the content of the Principles. A further three (7%) have heard of the Principles but are not familiar with their content. These levels of awareness are very similar to those recorded last year.

It is possible that, where the individual responding to the survey is not familiar with the ISC Principles, someone else in the organisation may be familiar with them. Even the small degree of unfamiliarity reported here may therefore be an exaggeration.

Figure 1: Familiarity with the ISC Principles

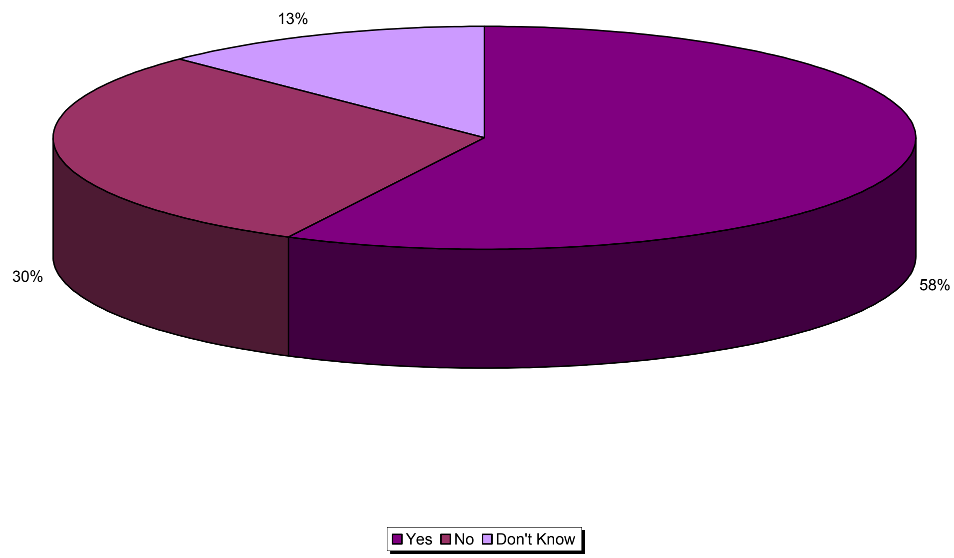


Base: All answering

[12] *Myners principles for institutional investment decision-making: review of progress*, HM Treasury, December 2004, p5

Twenty-three schemes (58%) report that their investment consultants or advisers have drawn their attention to the existence and importance of the ISC Principles.

Figure 2: Consultants and the ISC Principles

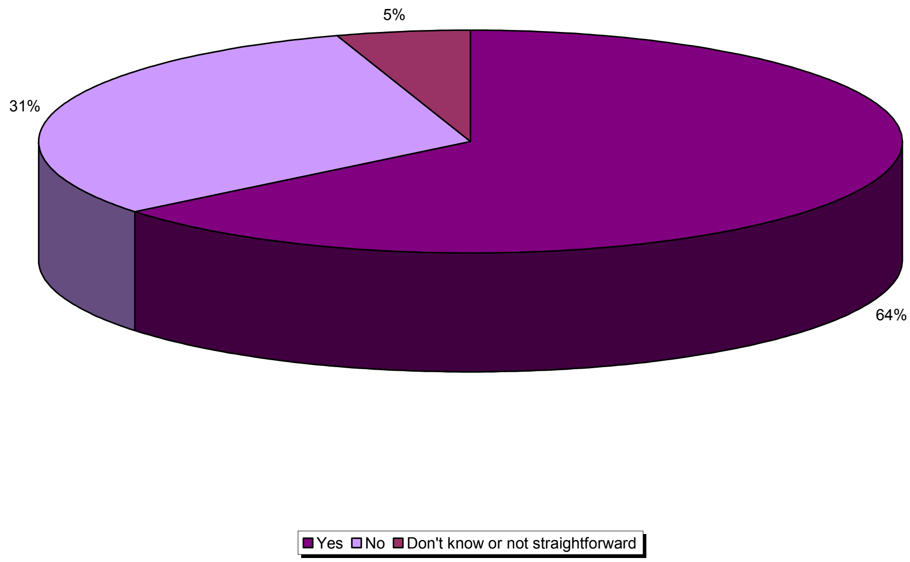


Base: all answering

Implementing the ISC Principles

Most schemes comply with the ISC Principles. Twenty-five (64%) of the 39 schemes which have heard of the ISC Principles have either incorporated them into managers' contracts directly or implemented them in other ways. Twelve schemes (31%) have not done this, while two say they do not know whether the Principles have been incorporated into managers' legal mandates. However, it would be wrong to conclude that those pension funds which have not incorporated the ISC Principles into fund managers' mandates are not engaging with the companies in which they invest. As set out on pages 10 and 11, a number of schemes are pursuing active engagement strategies through other means.

Figure 3: **Incorporation of the ISC Principles**



Base: All answering who have heard of the ISC Principles

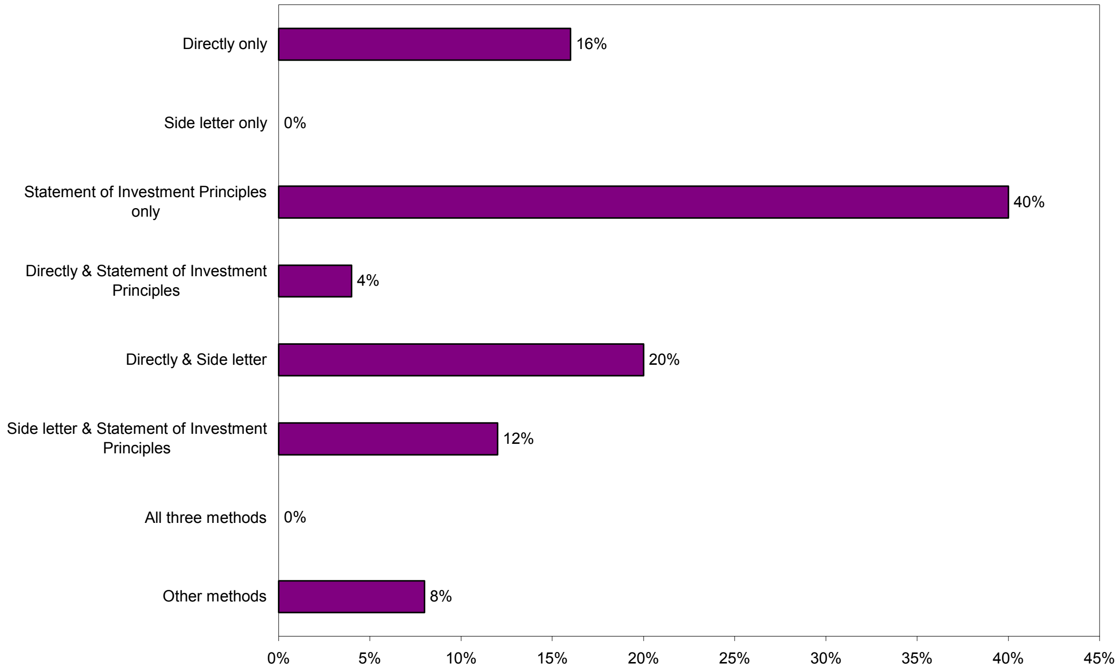
Method of Incorporation

Respondents were asked about the mechanisms through which they have incorporated the ISC Principles into managers' mandates. Some schemes have incorporated the Principles in more than one way. Of the 25 schemes which have implemented the Principles:

- ten (40%) have incorporated them into fund managers' contracts directly;
- four (16%) have incorporated them through a side letter;
- eighteen (72%) have included the ISC Principles in the scheme's own Statement of Investment Principles (SIP). As in the first NAPF Engagement Survey, this is the most popular method of implementation. Fund managers are legally obliged to act in accordance with the scheme's SIP; and
- two (8%) have incorporated them in other ways[13].

[13] For example, one scheme has delegated decisions to a third party which itself acts in accordance with the ISC Principles; another scheme has incorporated the ISC Principles into some contracts but not all.

Figure 4: Method of incorporation



Base: All answering who have incorporated ISC Principles into managers' contracts

Reasons for not implementing the ISC Principles

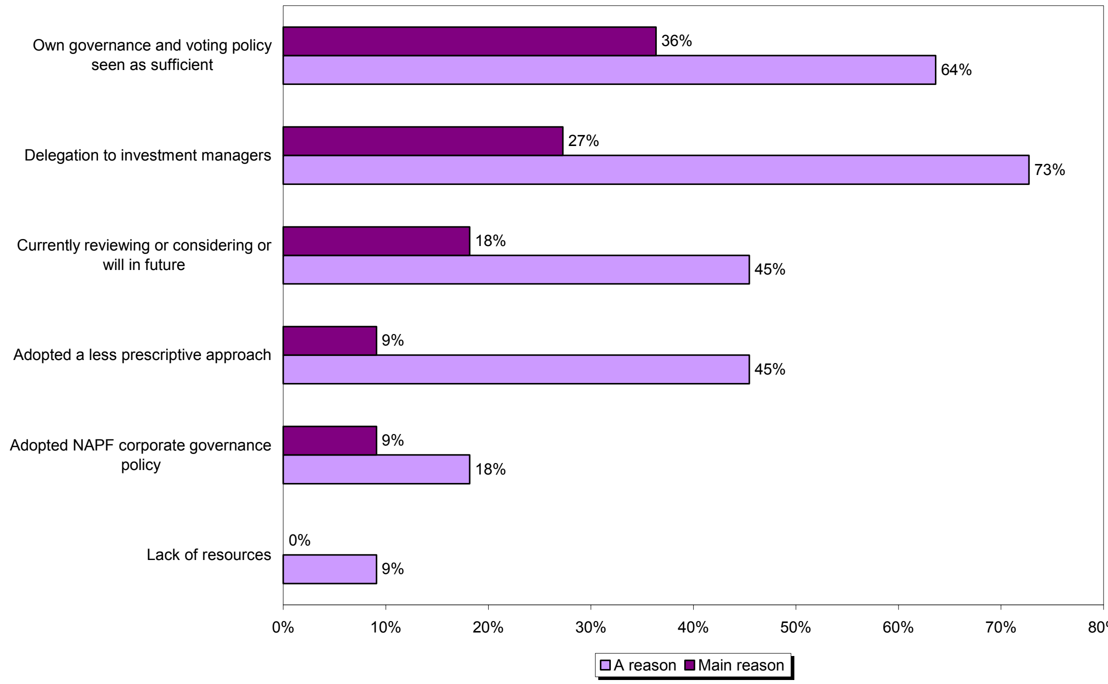
Where schemes have not implemented the ISC Principles, this is not because they have chosen not to engage with the companies in which they invest. Instead, it is most often because they have formulated their own corporate governance and voting policy, and/or because decisions have been delegated to investment managers who have their own engagement policies in place. In a recent report, the IMA found that 31 out of 35 managers surveyed included their policy on voting in client agreements[14].

Of the 12 schemes which have not incorporated the ISC Principles into managers' contracts and did not explain that they have implemented the Principles in other ways, 11 set out the reasons behind their decision not to implement the Principles.

Only one scheme cited a lack of resources as a factor in its decision not to implement the ISC Principles. Even for this scheme, a lack of resources was not the main reason for not implementing the Principles. It does not, then, seem that any of the large funds covered by this survey regard engagement with investee companies as a low resource priority.

[14] *Survey of fund managers' engagement with companies: year ended 20 June 2005*, p2. The 35 managers in the IMA survey were responsible for nearly £500 billion of UK equities in June 2005.

Figure 5: Reasons for not incorporating ISC Principles



Base: All answering who had not incorporated the ISC Principles; respondents could select more than one answer

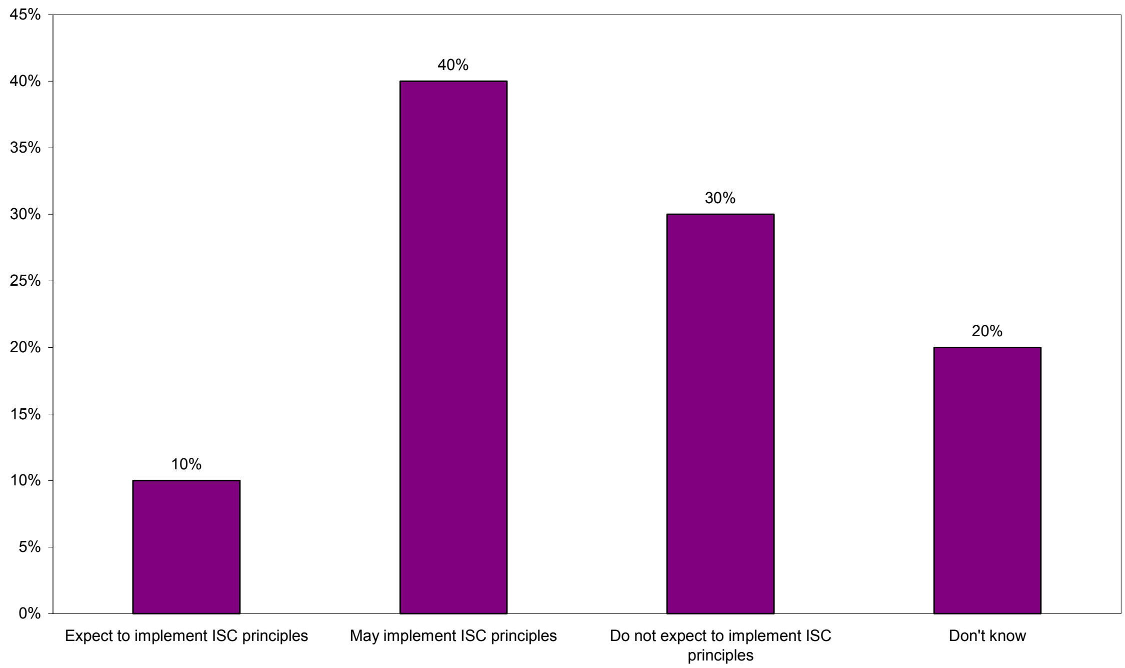
Future implementation of the ISC Principles

Ten schemes which have not incorporated the ISC Principles answered a question about their future plans concerning the Principles. Half of these are either reviewing whether to adopt the ISC Principles or expect to do so in future. Only three schemes are sure they will not implement the ISC Principles within the next two years. Progress therefore remains positive, with pension funds examining how they can exercise their responsibilities as shareholders most effectively.

One scheme said it is in the process of incorporating the ISC Principles and that, in the meantime, its Statement of Investment Principles stipulates that voting decisions should be based on the requirements in the Combined Code on Corporate Governance[15].

[15] *The Combined Code on Corporate Governance*, FSA, July 2003

Figure 6: Will the ISC Principles be implemented in the next two years?



Base: All answering who have not incorporated the ISC Principles

The ISC Principles and pension funds' engagement processes

Almost half (42%) of respondents with a good understanding of the ISC Principles believe they have made a difference to their scheme's engagement processes over the past two years. This compares with just over half of respondents to the previous NAPF Engagement Survey. At first sight, then, the number of schemes saying the ISC Principles have made a difference appears to have fallen. However, this finding is likely to reflect the fact that the earlier survey was concerned with pension funds' engagement in 2004, when the Principles were still only two years old. The initial impact that the Principles had on funds' engagement processes will therefore have been captured by the first survey, whereas this publication only details the progress that has been made since then.

Fund managers and engagement

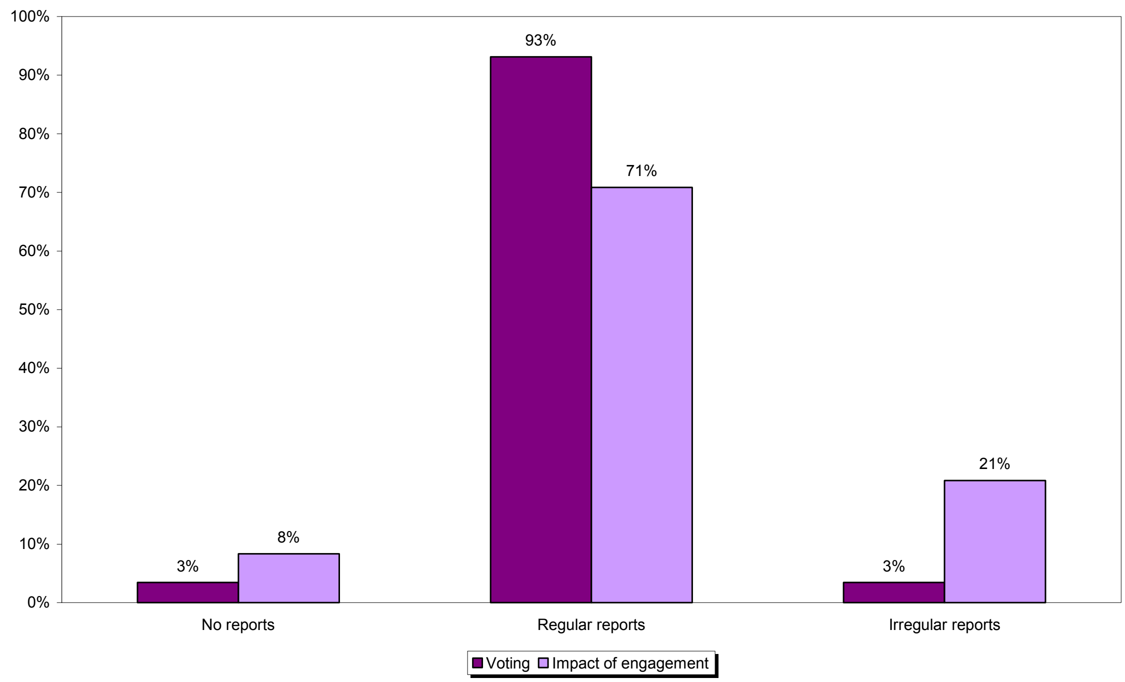
Managers' reports

The ISC Statement of Principles states that fund managers should report back to their clients or beneficial owners on their interaction with investee companies.

Receipt of reports by pension funds

This survey suggests that, even though not all large schemes have implemented the ISC Principles, the overwhelming majority receive regular reports from their managers on voting (93% of schemes who answered, up from 88% last year) and on wider engagement issues (71%). Even among schemes that have not incorporated the ISC Principles into managers' contracts, it is the norm to receive regular reports.

Figure 7: Regularity of reports



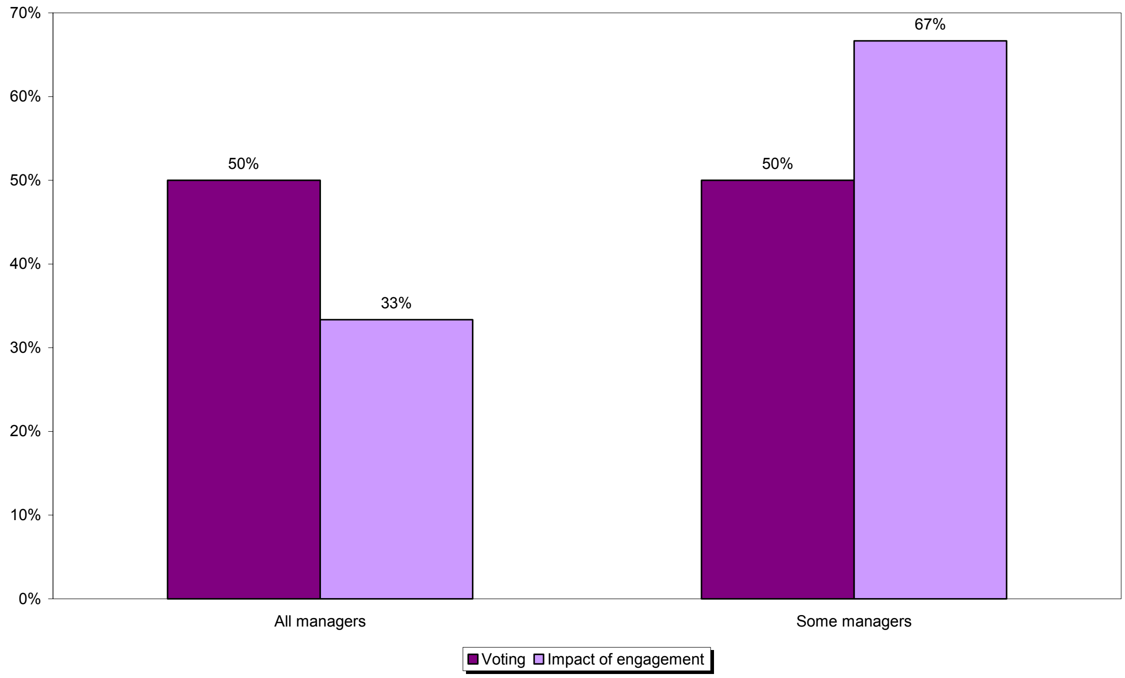
Base: All answering

This survey did not ask pension funds the precise frequency of reports from investment managers. However, the IMA found that the vast majority of fund managers issue quarterly reports to clients[16].

[16] *Survey of fund managers' engagement with companies: year ended 20 June 2005*, p28

While most schemes receive regular reports from at least *some* investment managers, half receive regular reports on voting from *all* their managers. One-third receive regular reports on wider engagement issues from all managers.

Figure 8: Do all managers issue reports?

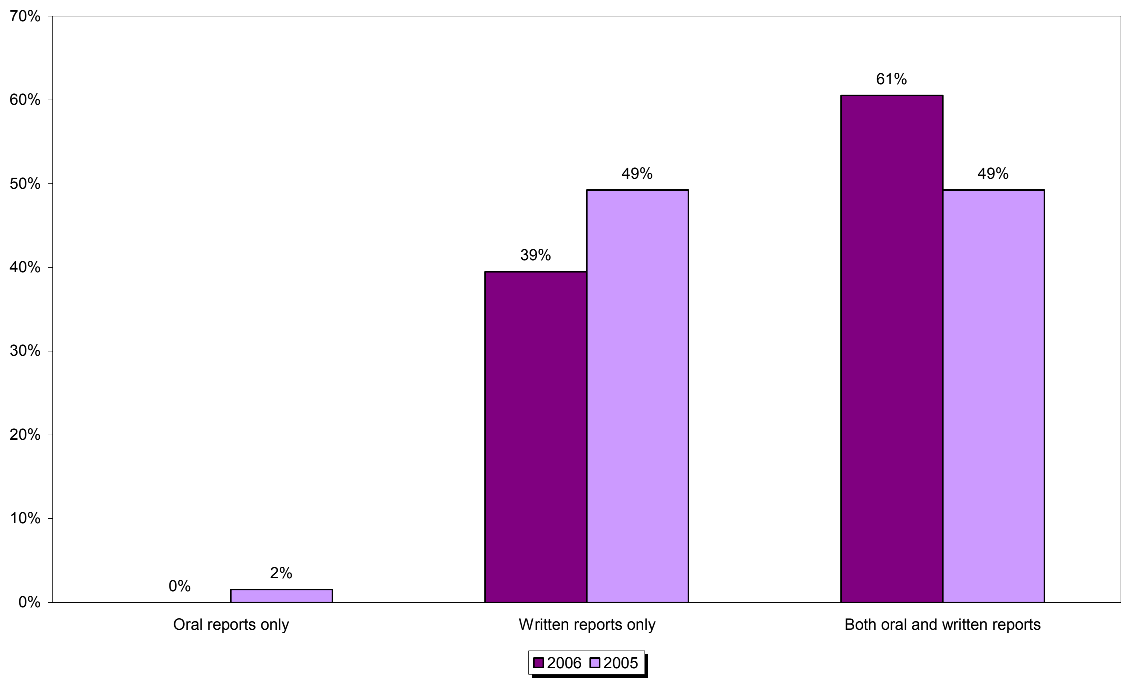


Base: All answering

Format of reports

No funds in the sample receive only oral reports from their investment managers. The majority (61% of those answering, up from 49% in the previous NAPF Engagement Survey) receive both oral and written reports, with the remainder receiving written reports only. Two schemes receive both oral and written reports from some managers but only written reports from others.

Figure 9: Type of reports received



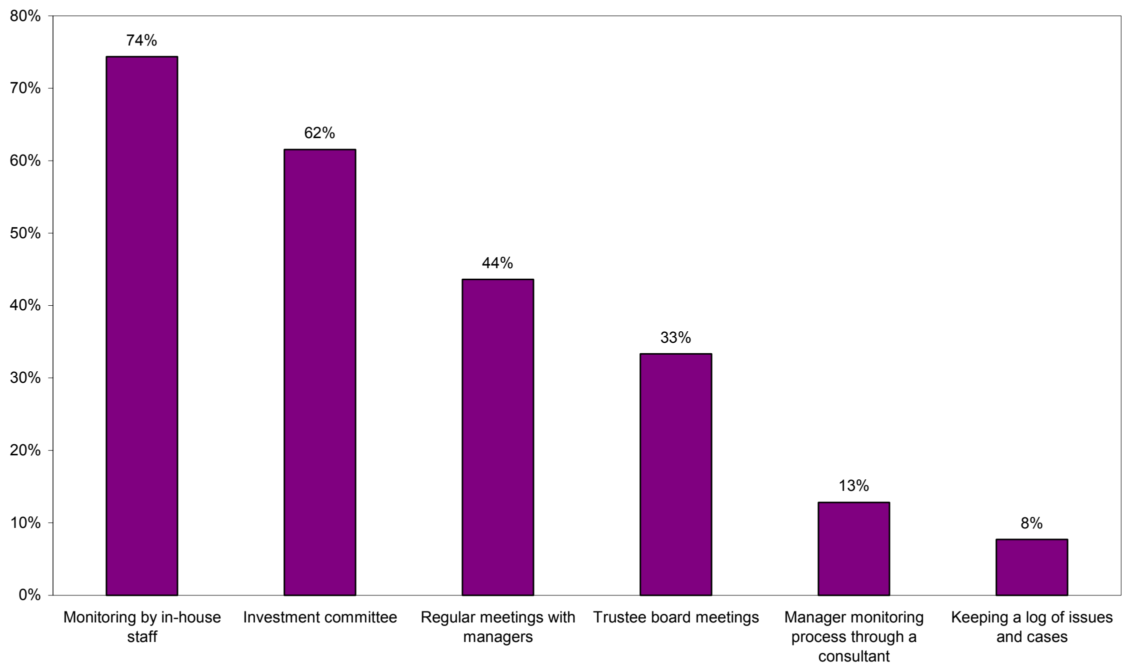
Base: All answering. The two schemes that receive both types of reports from some managers but only written reports from others are classed as receiving both oral and written reports.

Pension funds' monitoring of managers' reports

Of course, the receipt of reports from investment managers would be of limited value to schemes if they did not have a process for monitoring the content of these reports. Nearly three-quarters of schemes say that managers' reports are monitored by in-house staff. 62% say that reports are monitored by an investment committee of the main trustee board – double the 30% who gave this answer in the previous survey. One in three say reports are monitored at meetings of the full trustee board.

Twelve schemes (31%) use only one method to monitor these reports. At the other extreme, seven schemes (18%) use four methods. On average, schemes use two methods to monitor the reports they receive from fund managers.

Figure 10: How pension funds monitor managers' reports



Base: All answering; schemes could select more than one answer

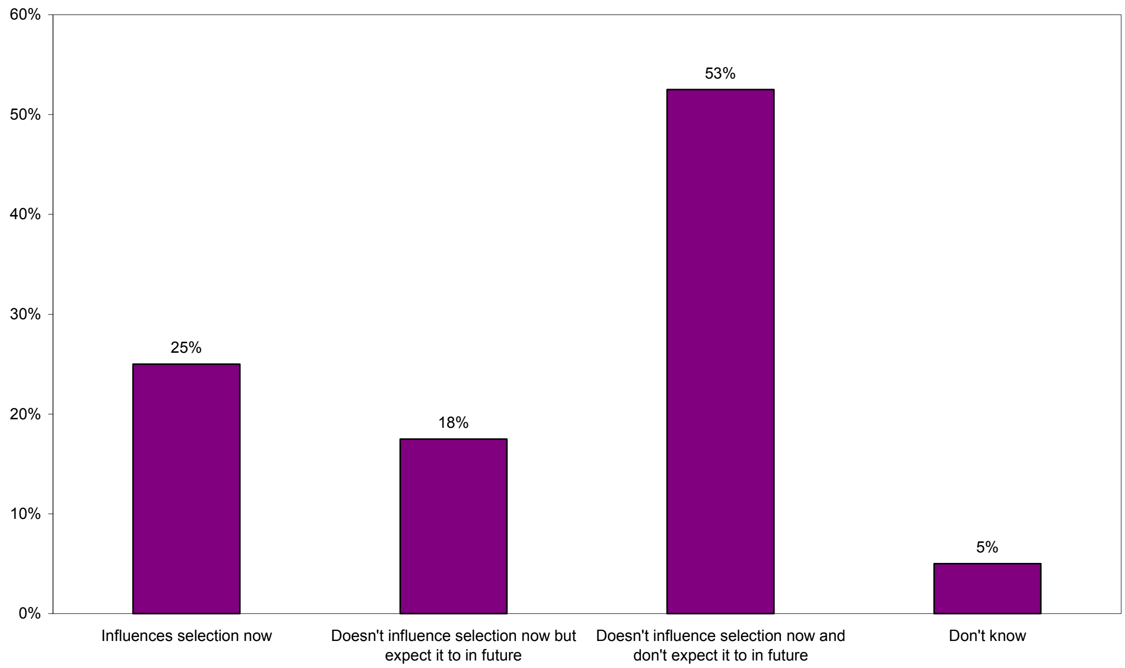
Engagement and manager selection

While engagement policies have frequently been incorporated into managers' contracts via the ISC Principles, and while most schemes receive regular reports from managers on engagement issues, one-quarter of schemes go further and say that their attitude towards engagement influences the selection of managers. Perhaps reflecting an increased emphasis on engagement more generally, a further 18% expect the scheme's attitude towards engagement to influence the selection of managers in the future. Twenty-one schemes (53%) say that they do not expect the scheme's attitude towards engagement to influence selection in the future (down slightly from 56% last year).

These findings may differ slightly from managers' own perceptions about whether engagement policies are influencing selection. Thirteen out of 35 managers surveyed by the IMA (37%) believe that engagement policies influence manager selection[17].

[17] *Survey of fund managers' engagement with companies: year ended 20 June 2005*

Figure 11: Engagement and manager selection



Base: All answering

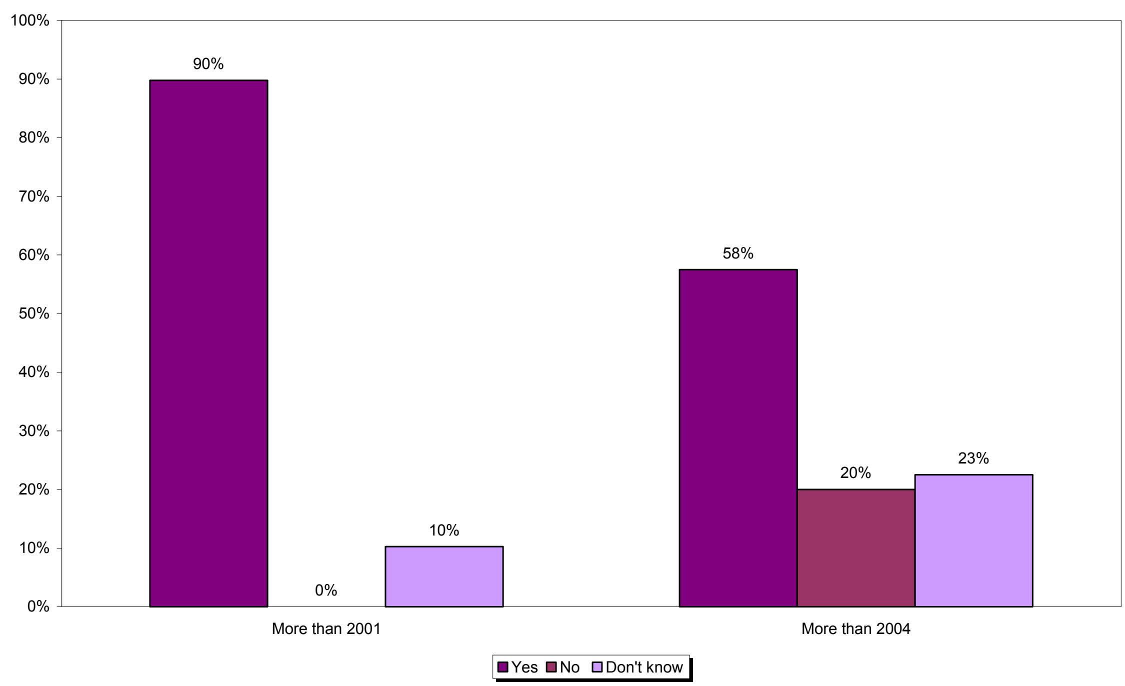
Resources devoted to engagement

Myners recommended that "where [shareholders] identify problems, they should actively engage with the company to ensure that they are tackled rather than merely waiting and hoping that action will be taken"[18]. This requires resources to be devoted to engagement, either by the shareholders themselves or by the agents acting on their behalf.

Fund managers' resources

In the majority of cases, fund managers will engage with companies on their clients' behalf. It is encouraging, therefore, that nine out of ten schemes perceive that their fund managers devote more resources to engagement with investee companies today than they did in 2001 (up slightly from 85% in the previous survey). Nearly two-thirds of these (and 58% of all schemes) say that part of this increase has taken place since 2004. No respondents think their fund managers devote fewer resources to engagement today than they did in 2001.

Figure 12: Fund managers' engagement resources



Base: All answering

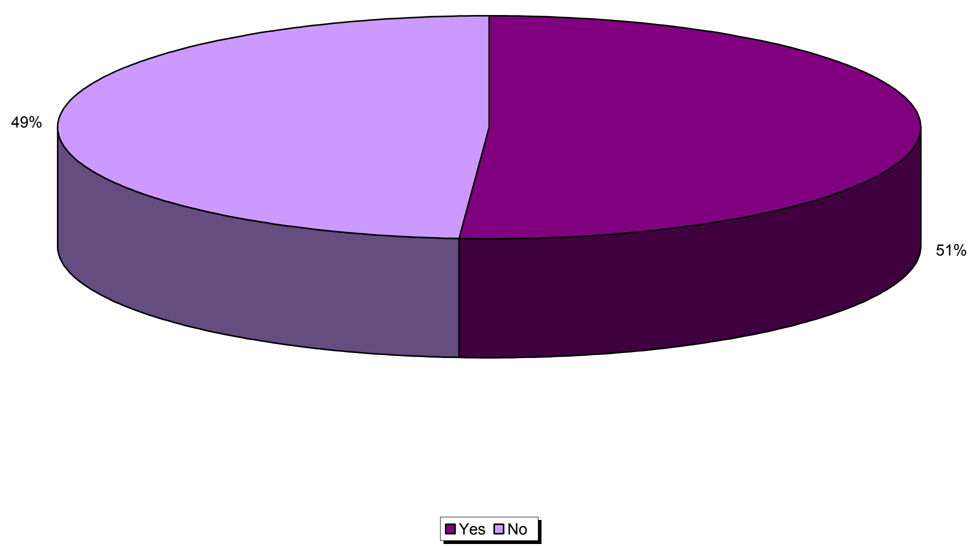
[18] Myners Review, p89

Data collected by the IMA supports pension funds' perception that fund managers are devoting more resources to engagement. In its survey of managers, the IMA found that the number of staff devoted to engagement rose by 10% in the year to June 2005, having already risen by 10% in the previous year. This survey also showed that the overwhelming majority of fund managers meet with company management at least once a year. One-third meet all investee companies at least twice a year[19].

Pension funds' internal resources for engagement

In addition to the increased in resources devoted to engagement on pension funds' behalf by fund managers, twenty-one schemes in the sample (51%) have allocated internal resources to engagement.

Figure 13: Do you have an internal resource for engagement?



Base: All answering

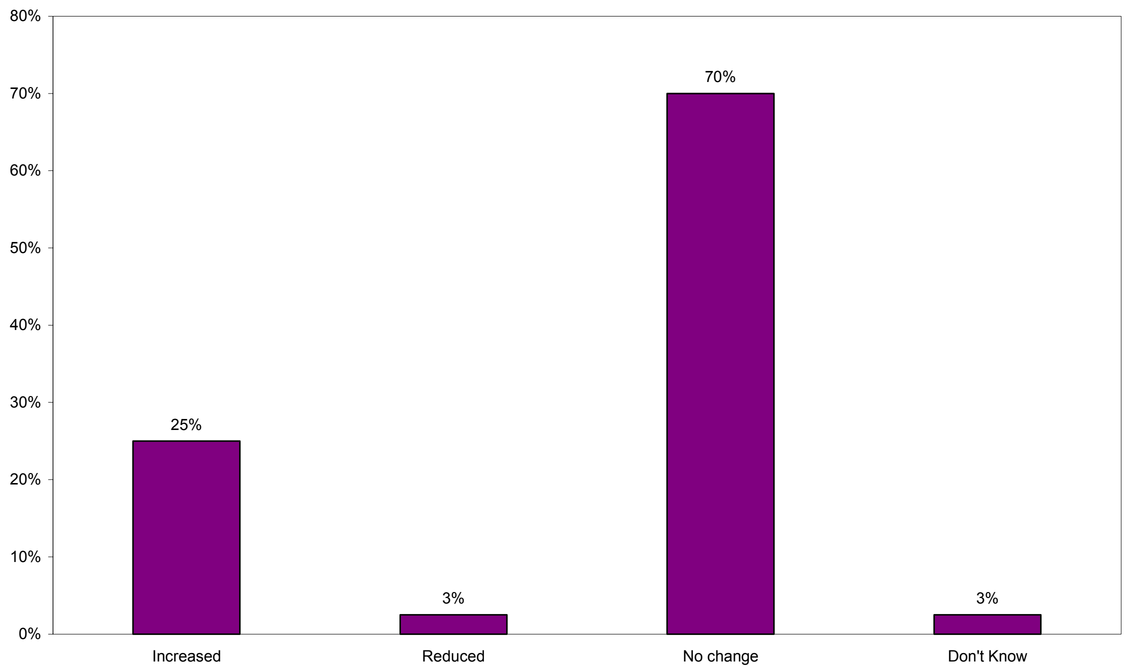
Ten schemes (48% of those with internal resources devoted to engagement; 25% of all schemes answering this question) say they have increased the level of these resources during the past two years. While this number is down slightly compared with the

[19] *Survey of fund managers' engagement with companies: year ended 20 June 2005*, pages 11 and 16

previous *NAPF Engagement Survey* (which showed 36% of all schemes having increased their internal engagement resources during the previous two years), the level of resources devoted to engagement by large pension funds is continuing to rise. As with the proportion reporting that the ISC Principles have made a difference, one might have expected that the initial impact would be greater than the subsequent impact.

One scheme allocated internal resources to engagement two years ago but no longer does so. However, this reduction in internal resources allocated to engagement has taken place at a time when the scheme's fund managers have increased their engagement resources. The overall level of resources allocated to engagement by this scheme – whether paid for directly or through fund managers' fees – could therefore have risen.

Figure 14: Change in level of internal resources allocated to engagement



Base: All answering

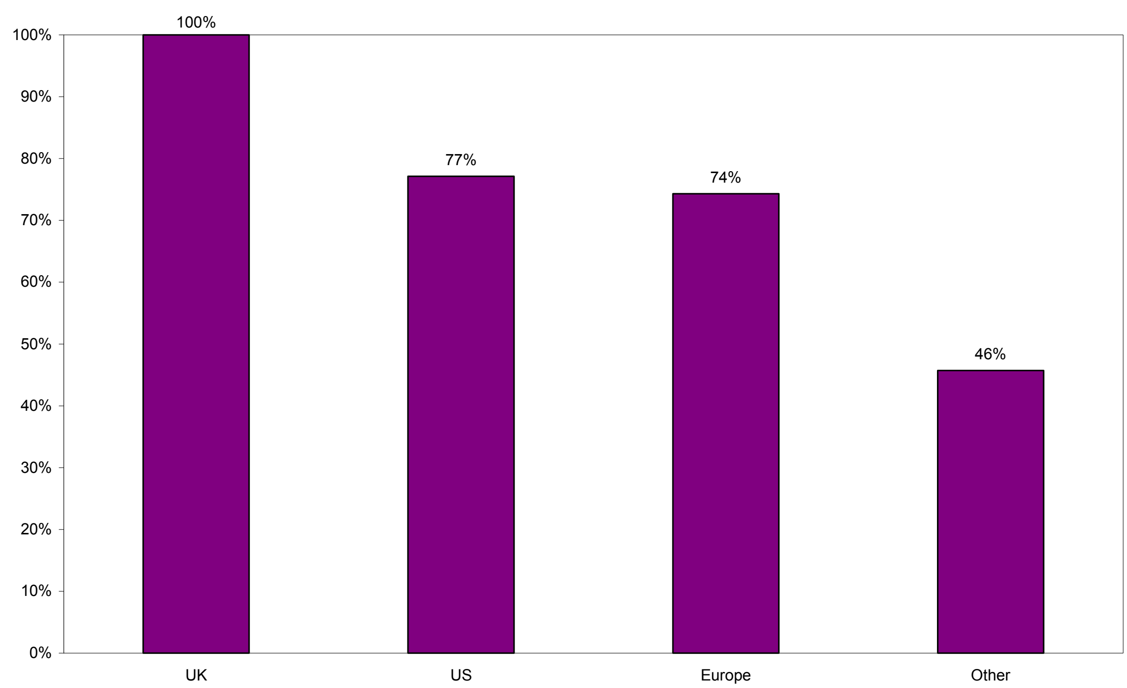
Voting

Voting in the UK and in overseas markets

Twenty-five schemes said they exercise voting rights themselves. All of these vote on resolutions affecting companies listed in the UK. Most also exercise these rights in relation to companies listed in the US (77%) and Europe (74%) – though some specified that they do so only where it is cost effective. Almost half of those answering also exercise voting rights in other markets – typically in Japan, the Far East and/or Australia.

Two schemes specified that, while they usually try to vote wherever possible, they refrain from casting votes when this can restrict their ability to sell the shares.

Figure 15: Markets in which schemes exercise votes



Base: All answering who vote their shares

Voting reference agencies

Subscription to agencies

Twenty schemes (49%, up from 40% last year) subscribe to one or more voting reference agency or to similar services. The most commonly used agencies are RREV – which uses the NAPF's corporate governance policy – and PIRC (nine schemes each), followed by Hermes (four schemes). Three schemes in the sample subscribe to Manifest, with one subscribing to EIRIS.

Those schemes who do not subscribe generally rely on fund managers' recommendations, which may in turn be influenced by the recommendations received from a voting reference agency.

Reviewing agencies' recommendations

Of the 20 schemes that subscribe to voting reference agencies, 19 answered questions about how they respond to agencies' recommendations. Seventeen of these schemes (89%) actively review the recommendations they receive[20], while thirteen (68%) have a process for recording the rejection of recommendations. Where such a process is not in place, this is sometimes because schemes do not reject recommendations or because a third party can reject recommendations on the scheme's behalf.

Sixteen of the 20 schemes (80%) report having at some stage rejected a recommendation from a voting reference agency, suggesting that voting decisions are reached only after careful thought. Most commonly, such decisions have been taken on the basis of in-house analysis (14 schemes). Five have rejected an agency's recommendation after meeting the investee company directly to discuss the issue in question. Four have rejected an agency's recommendation after receiving a conflicting recommendation from another agency.

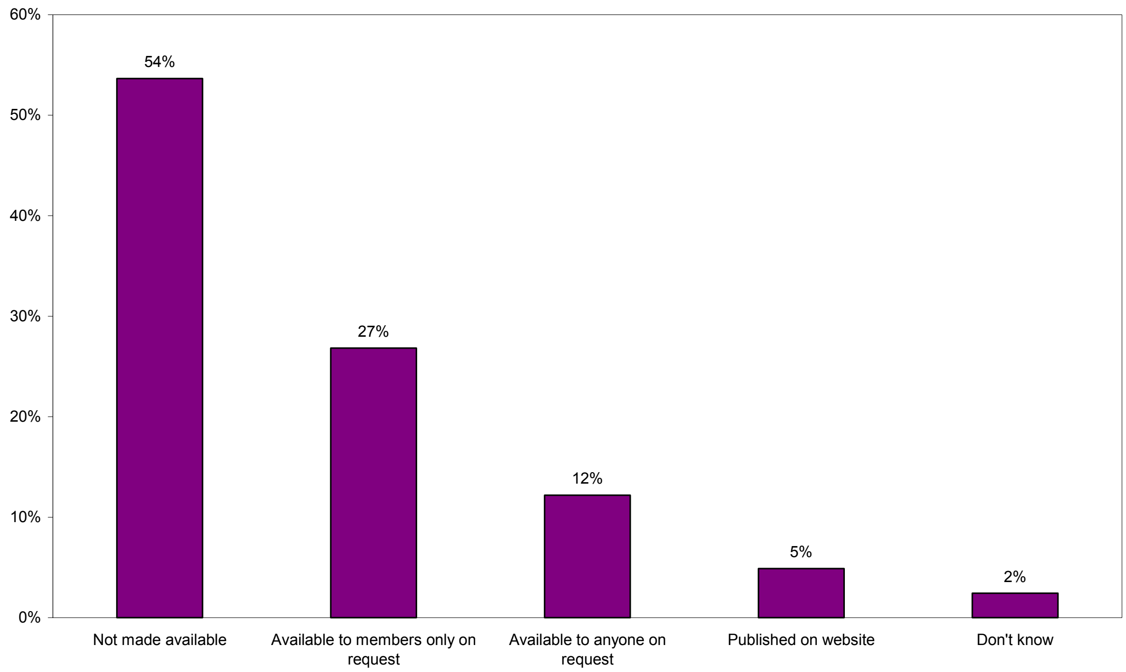
Disclosure of how pension funds exercise their voting rights

Eighteen schemes (44%) disclose how they vote the shares they hold. Most of these release this information only to scheme members on request.

However, seven schemes reveal this information to interest groups and members of the public as well as to scheme members. These include two schemes that publish details of how they have voted on their website and a further two that plan to do so soon.

[20] Two of these 17 schemes only review controversial recommendations.

Figure 16: Voting disclosure



Base: All answering

Pension funds are not the only institutions that can disclose how votes have been cast. In some cases, fund managers will themselves disclose this information. As with pension funds, the trend among fund managers is towards increased voluntary disclosure[21].

Ministers "would like to encourage a voluntary approach" to increased disclosure[22]. This survey, along with the recent decisions taken by fund managers, suggests that investors are moving in this direction. The ISC will work to increase voluntary disclosure still further.

However, the Government is still considering a move towards compulsory disclosure. Reserve powers sought under the Company Law Reform Bill would allow Ministers to compel institutional shareholders to disclose how they have voted on particular resolutions. These details could have to be provided both to beneficiaries and to those with no direct interest in the investment returns achieved. The feedback the NAPF has received indicates that there is virtually no demand from pension scheme members for such information.

[21] Earlier this year, it was reported that Hermes, which manages the largest UK pension fund (the BT pension fund) had become the twelfth UK fund manager to decide to publish its voting record (*Financial Times*, 21 April 2006).
[22] Alistair Darling, *Hansard*, 6 June 2006, col.135

Along with its partners in the ISC, the NAPF does not believe that this kind of compulsory "after the event" disclosure represents the best approach to improving transparency. Instead, we have argued that "proactive prior disclosure" can be clearer for members and less burdensome for pension funds. Under this approach, schemes communicate their general voting policy to members in advance.

Compelling disclosure on a vote-by-vote basis would require considerable upgrading of systems at a significant cost to pension schemes. Despite ongoing improvements from the greater use of electronics, the voting chain remains complex – involving the beneficial owner, a fund manager, a custodian, the custodian's nominee, a registrar and sometimes a proxy voting service. This can make it difficult for the initiators of voting instructions to determine whether their instructions have been received and acted upon. In some cases, a vote may not be validated by the registrar; in others, votes may be determined by a show of hands without a formal poll being called.

Any significant new costs imposed on schemes would ultimately be met either by the sponsoring employer or by the scheme's members.

How does stock lending affect voting?

Thirty-nine schemes answered questions about how stock lending affects their ability to exercise the voting rights attached to the shares they own. Three-quarters say that stock lending does not impair their ability to influence decisions affecting the strategic direction of companies they invest in. Thirty schemes either do not lend stock (36%) or recall it when they want to regain control of voting rights (41%).

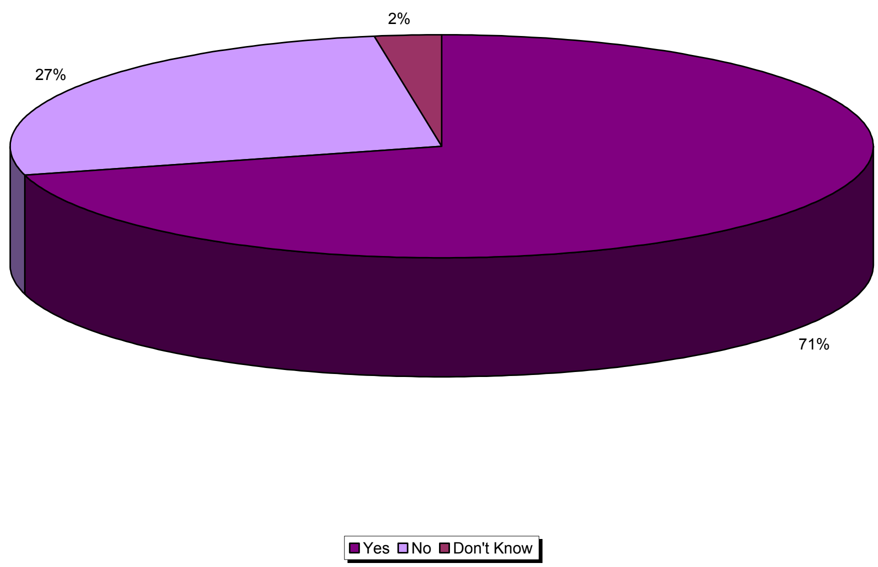
Only one of the fourteen schemes that recalls stock does so every time there is a vote. Most commonly, stock is recalled only where the vote is contentious (86% of those recalling stock). Two schemes volunteered that, when deciding whether to recall stock, they consider whether the hedge funds to whom they have lent it might vote in a way that would be unhelpful to the company's long-term owners.

Pension funds’ engagement policies and corporate governance standards

Scheme engagement policies

Twenty-nine schemes (71%) have their own policy on corporate governance, engagement and/or corporate social responsibility. Eleven schemes (27%) do not have their own policy[23].

Figure 17: Do funds have their own engagement / corporate governance policies?



Base: All answering

Corporate governance standards: pension funds’ perceptions

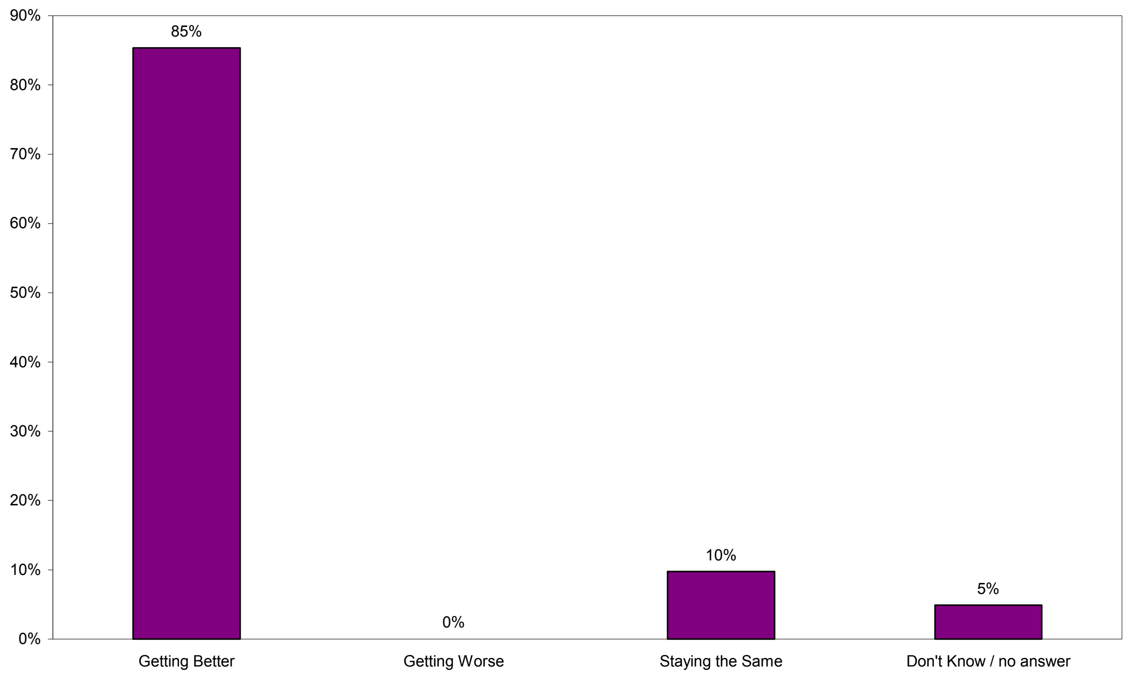
Most large pension funds are confident that, overall, the UK’s corporate governance environment is improving. If they are right, then even investors who have not stepped up their own engagement efforts in recent years (including individuals who hold shares

[23] These include one scheme which used to have its own policy, but which followed Hermes when the latter replaced its corporate governance guidelines with the Combined Code. This move was undertaken in order to ”simplify the overall body of corporate governance for UK companies” (Hermes press release, 31 January 2005). Convergence towards a single Code, with investors following similar practices, is to be welcomed.

as well as institutional investors) will have benefited from the way that pension funds' actions have affected corporate behaviour.

Not a single respondent believes that governance standards in the UK are deteriorating. Thirty-five schemes (85%) believe that standards are improving.

Figure 18: How are governance standards in UK companies changing?



Base: All respondents

The perception that corporate governance standards are improving indicates that the efforts pension funds continue to make in the field of engagement, illustrated throughout this survey, are having a positive effect. Most of the pension funds surveyed have implemented the ISC Principles (with the remainder generally pursuing similar objectives through other means). Meanwhile, it is the norm for large pension funds to receive regular reports on voting from their fund managers. Both pension funds and the managers to whom they award mandates are stepping up the level of resources devoted to engagement. In summary, the progress made to date demonstrates that the voluntary approach to engagement is working.

Appendix: The ISC Statement of Principles

The responsibilities of institutional shareholders and agents – Statement of Principles, updated September 2005

1. Introduction and Scope

This Statement of Principles has been drawn up by the Institutional Shareholders' Committee[24]. It develops the principles set out in its 1991 statement "The Responsibilities of Institutional Shareholders in the UK" and expands on the Combined Code on Corporate Governance of June 1998. It sets out best practice for institutional shareholders and/or agents in relation to their responsibilities in respect of investee companies in that they will:

- set out their policy on how they will discharge their responsibilities - clarifying the priorities attached to particular issues and when they will take action – see 2 below;
- monitor the performance of, and establish, where necessary, a regular dialogue with investee companies – see 3 below;
- intervene where necessary - see 4 below;
- evaluate the impact of their engagement – see 5 below; and
- report back to clients/beneficial owners – see 5 below.

In this statement the term "institutional shareholder" includes pension funds, insurance companies, and investment trusts and other collective investment vehicles. Frequently, agents such as investment managers are appointed by institutional shareholders to invest on their behalf.

This statement covers the activities of both institutional shareholders and those that invest as agents, including reporting by the latter to their institutional shareholder clients. The actions described in this statement in general apply only in the case of UK listed companies. They can be applied to any such UK company, irrespective of market capitalisation, although institutional shareholders' and agents' policies may indicate *de minimis* limits for reasons of cost-effectiveness or practicability. Institutional

[24] In 1991 the members of the Institutional Shareholders' Committee were: the Association of British Insurers; the Association of Investment Trust Companies; the British Merchant Banking and Securities Houses Association; the National Association of Pension Funds; and the Unit Trust Association. In 2005, the members are: the Association of British Insurers; the Association of Investment Trust Companies; the National Association of Pension Funds; and the Investment Management Association.

shareholders and agents should keep under review how far the Principles in this Statement can be applied to other equity investments.

The policies of engagement set out below do not constitute an obligation to micro-manage the affairs of investee companies, but rather relate to procedures designed to ensure that shareholders derive value from their investments by dealing effectively with concerns over under-performance. Nor do they preclude a decision to sell a holding, where this is the most effective response to such concerns.

Fulfilling fiduciary obligations to end-beneficiaries in accordance with the spirit of this Statement may have implications for institutional shareholders' and agents' resources. They should devote appropriate resources, but these should be commensurate with the benefits for beneficiaries. The duty of institutional shareholders and agents is to the end beneficiaries and not to the wider public.

2. Setting out their policy on how they will discharge their responsibilities

Both institutional shareholders and agents will have a clear statement of their policy on engagement and on how they will discharge the responsibilities they assume. This policy statement will be a public document. The responsibilities addressed will include each of the matters set out below.

- How investee companies will be monitored. In order for monitoring to be effective, where necessary, an active dialogue may need to be entered into with the investee company's board and senior management.
- The policy for meeting with an investee company's board and senior management.
- How situations where institutional shareholders and/or agents have a conflict of interest will be minimised or dealt with.
- The strategy on intervention.
- An indication of the type of circumstances when further action will be taken and details of the types of action that may be taken.
- The policy on voting.

Agents and their institutional shareholder clients should agree by whom these responsibilities are to be discharged and the arrangements for agents reporting back.

3. Monitoring performance

Institutional shareholders and/or agents, either directly or through contracted research providers, will review Annual Reports and Accounts, other circulars, and general meeting resolutions. They may attend company meetings where they may raise questions about investee companies' affairs. Also investee companies will be monitored to determine when it is necessary to enter into an active dialogue with the investee company's board and senior management. This monitoring needs to be regular, and the process needs to be clearly communicable and checked periodically for its effectiveness. Monitoring may require sharing information with other shareholders or agents and agreeing a common course of action.

As part of this monitoring, institutional shareholders and/or agents will:

- seek to satisfy themselves, to the extent possible, that the investee company's board and sub-committee structures are effective, and that independent directors provide adequate oversight; and
- maintain a clear audit trail, for example, records of private meetings held with companies, of votes cast, and of reasons for voting against the investee company's management, for abstaining, or for voting with management in a contentious situation.

In summary, institutional shareholders and/or agents will endeavour to identify problems at an early stage to minimise any loss of shareholder value. If they have concerns and do not propose to sell their holdings, they will seek to ensure that the appropriate members of the investee company's board are made aware of them. It may not be sufficient just to inform the Chairman and/or Chief Executive. However, institutional shareholders and/or agents may not wish to be made insiders. Institutional shareholders and/or agents will expect investee companies and their advisers to ensure that information that could affect their ability to deal in the shares of the company concerned is not conveyed to them without their agreement.

4. Intervening when necessary

Institutional shareholders' primary duty is to those on whose behalf they invest, for example, the beneficiaries of a pension scheme or the policyholders in an insurance company, and they must act in their best financial interests. Similarly, agents must act in the best interests of their clients. Effective monitoring will enable institutional shareholders and/or agents to exercise their votes and, where necessary, intervene objectively and in an informed way. Where it would make intervention more effective, they should seek to engage with other shareholders.

Many issues could give rise to concerns about shareholder value. Institutional shareholders and/or agents should set out the circumstances when they will actively intervene and how they propose to measure the effectiveness of doing so. Intervention should be considered by institutional shareholders and/or agents regardless of whether an active or passive investment policy is followed. In addition, being underweight is not, of itself, a reason for not intervening. Instances when institutional shareholders and/or agents may want to intervene include when they have concerns about:

- the company's strategy;
- the company's operational performance;
- the company's acquisition/disposal strategy;
- independent directors failing to hold executive management properly to account;
- internal controls failing;
- inadequate succession planning;
- an unjustifiable failure to comply with the Combined Code;
- inappropriate remuneration levels/incentive packages/severance packages; and
- the company's approach to corporate social responsibility.

If boards do not respond constructively when institutional shareholders and/or agents intervene, then institutional shareholders and/or agents will consider on a case-by-case basis whether to escalate their action, for example, by:

- holding additional meetings with management specifically to discuss concerns;
- expressing concern through the company's advisers;
- meeting with the Chairman, senior independent director, or with all independent directors;
- intervening jointly with other institutions on particular issues;
- making a public statement in advance of the AGM or an EGM;
- submitting resolutions at shareholders' meetings; and
- requisitioning an EGM, possibly to change the board.

Institutional shareholders and/or agents should vote all shares held directly or on behalf of clients wherever practicable to do so. They will not automatically support the board; if they have been unable to reach a satisfactory outcome through active dialogue then they will register an abstention or vote against the resolution. In both instances it is good practice to inform the company in advance of their intention and the reasons why.

5. Evaluating and reporting

Institutional shareholders and agents have a responsibility for monitoring and assessing the effectiveness of their engagement. Those that act as agents will regularly report to their clients details on how they have discharged their responsibilities. This should include a judgement on the impact and effectiveness of their engagement. Such reports will be likely to comprise both qualitative as well as quantitative information. The particular information reported, including the format in which details of how votes have been cast will be presented, will be a matter for agreement between agents and their principals as clients.

Transparency is an important feature of effective shareholder activism. Institutional shareholders and agents should not however be expected to make disclosures that might be counterproductive. Confidentiality in specific situations may well be crucial to achieving a positive outcome.

6. Conclusion

The Institutional Shareholders' Committee believes that adoption of these Principles will significantly enhance how effectively institutional shareholders and/or agents discharge their responsibilities in relation to the companies in which they invest. To ensure that this is the case, the Institutional Shareholders' Committee will monitor the impact of this Statement with a view to further reviewing and refreshing it, if needs be, in 2007 in the light of experience and market developments.

National Association of Pension Funds Limited

NIOC House
4 Victoria Street
London SW1H 0NX

Telephone 020 7808 1300
Facsimile 020 7222 7585
Email membership@napf.co.uk
www.napf.co.uk

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