NAPF

Securing the future of pensions

Pension Funds' Engagement with Companies

August 2007

NAPF Research Report 8

Key points

Large pension funds are continuing to take their responsibilities as shareholders seriously and are actively engaging with the companies in which they invest. After surveying pension funds with more than £1 billion under management, the NAPF found that:

- **The ISC Statement of Principles:** Every fund surveyed was aware of the Institutional Shareholders' Committee's Statement of Principles and three quarters were familiar with its content. Almost two thirds had incorporated the Principles into managers' contracts, with the very largest funds most likely to have done so.

- **Corporate governance standards improving:** There is a strong perception that governance standards in UK companies are improving. Eight out of ten funds surveyed believe standards are continuing to improve. None said that standards are deteriorating.

- **Reports from agents:** Pension funds are demanding regular and comprehensive reports from agents who vote or engage with companies on their behalf. On average, managers report to funds at least twice a year.

- **Impact of engagement:** More than three quarters of funds surveyed have helped change remuneration packages, board membership or corporate strategy by engaging with companies in which they invest.

- **Resources for engagement:** Resources devoted to engagement have increased since the Myners Review was published in 2001. One third of funds surveyed say resources for engagement have continued to grow during the past two years.

- **Global voting:** Voting is becoming more international. It is very much the norm for votes to be exercised in the US, Japan and at least some European markets, as well as in the UK. The number of funds saying they vote in overseas markets has increased since 2006.

- **Voting disclosure:** Responses were received before the ISC published its new framework on voting disclosure. Nonetheless, a small number of funds – including some of the largest – voluntarily disclose how votes are cast at company meetings not only to scheme members but also to the wider public.

- **Stock lending:** Almost three quarters of funds either do not lend stock or recall it to regain control of voting rights.

- **Class actions:** More than two thirds of respondents had collected money following a class action settlement. A small number had been active participants in class action cases.

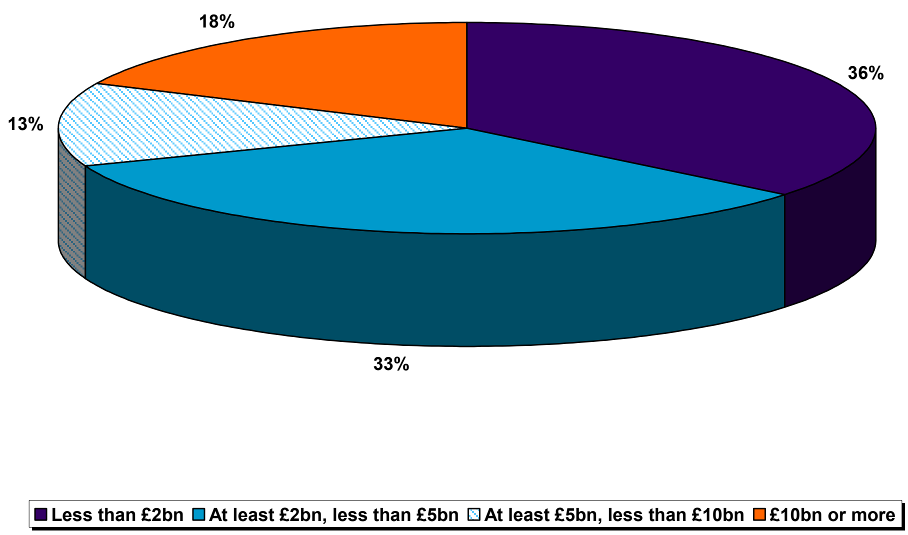
Contents

Introduction

About the survey – who responded?

This report presents the results of the NAPF's third Shareholder Engagement Survey. The 2007 Shareholder Engagement Survey questionnaire was sent to all NAPF fund members with £1 billion or more under management. Responses were received from 39 funds[1]. Although the number of respondents is quite small, the sums of money they invest are substantial. Between them, respondents have combined assets totalling more than £230 billion. Twelve of the funds surveyed have assets in excess of £5 billion.

Figure 1: Respondents by value of assets under management[2]



Base: All respondents (39 pension funds)

The NAPF is grateful to all the funds that responded. Not all questions were relevant to all respondents, so the number answering each question is stated throughout the report.

The context: reviewing the Myners Review

During 2007, NAPF is reviewing the Myners Principles on behalf of HM Treasury. The results published here will help inform that review.

1 In some multi-employer funds, different sections of the scheme will have their own voting and engagement policies and processes. Two responses were received from individual sections with less that £1 billion in assets. These have been included in the results.

2 Responses were submitted between March 2007 and July 2007. In a few cases, the date of response may determine which segment of the pie chart a respondent features in. The chart Includes two respondents who did not detail the value of assets under management; in these cases, data was taken from *Pension Funds and Their Advisers 2007* (AP Information Services/NAPF)

Institutional investment in the UK six years on, published by NAPF in January, collated evidence on progress to date and asked how the Myners Principles might be updated in the light of changes to the pensions landscape since 2001. 47 responses were received from pension funds and other interested parties. These are being analysed over the summer and NAPF will submit a report with recommendations to the Government by the end of October. The review process has been welcomed by HM Treasury as "an important step towards greater ownership of the Principles by the pensions community"[3].

Myners on shareholder intervention

In his 2001 report on institutional investment, Paul Myners welcomed the more activist stance taken by institutional investors during the preceding years, which culminated in the publication of the Combined Code on Corporate Governance in 1998. However, he concluded that such developments were "not always sufficient".

In order to make further progress, the Myners Review recommended that: "Managers should have an explicit strategy, elucidating the circumstances in which they will intervene in a company; the approach they will use in doing so; and how they measure the effectiveness of this strategy". 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."[4]

The changing landscape for shareholder intervention

Since the Myners Review was published, pension funds' equity holdings have become smaller in size and more international in shape. This is partly because defined benefit funds are seeking to match their assets and liabilities more closely (e.g., because the schemes are maturing or in order to make the funding position less volatile), and partly because trustees are looking for more diverse sources of return. Meanwhile, the proportion of UK-listed shares held by overseas investors has increased from 36% in 2000 to 40% in 2006[5].

Table 1: Equities as a percentage of pension fund assets [6]

	End of 2000	End of 2005
All equities	65%	58%
UK equities	46%	34%
Overseas equities	19%	23%

Smaller and more international equity holdings might make it less straightforward for some pension funds to engage effectively as shareholders in UK companies. Nonetheless, with around one third of self-administered funds' assets in UK equities at the end of 2005, the scope for effective engagement in this market by pension funds and their agents remains considerable. This is particularly the case where big indexed

3 Ed Balls MP, then Economic Secretary to the Treasury, Foreword to Institutional Investment in the UK Six Years On, NAPF, January 2007

4 Myners Review, p93

5 *Share ownership – a report on ownership of UK shares as at 31 December 2006*, ONS, July 2007

6 ONS MQ5 data

funds hold a substantial proportion of a company's stock on behalf of a large number of beneficial owners, or where actively managed funds have a large shareholding in a particular company as a result of stock selection.

Nor is it the case that funds are confining their engagement activities to UK companies. This survey shows a marked year-on-year increase in voting in overseas markets, and confirms that some UK funds have been active participants in class actions against US companies in which they invest.

Pension funds and the ISC Principles

Summary

- Awareness of the Statement of Principles published by the Institutional Shareholders' Committee (ISC) is high. All pension funds surveyed are aware of the ISC Statement of Principles, and three-quarters are familiar with its content.

- Two thirds of funds surveyed have incorporated the ISC Statement of Principles into managers' contracts – something which has been achieved in a variety of ways. The very largest funds are most likely to have implemented the Principles. Few respondents have a firm expectation that the Principles will not be implemented over the next two years.

- For many, the ISC Principles provide a formal framework for the good practices they were already developing. Almost half of those who have implemented the Principles said they would take the same approach to engagement even if the Principles had not been implemented.

The Institutional Shareholders' Committee Statement of Principles

The Myners Review's conclusions on the importance of shareholder engagement are reflected in the Institutional Shareholder' Committee's Statement of Principles on the responsibilities of institutional shareholders and their agents[7]. The Statement was first issued in 2002 and was refreshed in 2005. It is included in this report as Appendix 2.

Box 1: The ISC Statement of Principles

The ISC's Statement of Principles sets out best practice for institutional shareholders and their agents in respect of the companies in which they invest. 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, and establish, where necessary, a regular dialogue with investee companies;
- intervene where necessary;
- evaluate the impact of their engagement; and
- report back to clients/beneficial owners.

In general, these actions apply to UK listed companies. However, the Statement encourages shareholders to keep their applicability to other equity investments under review.

7 The Institutional Shareholders Committee comprises NAPF, the Association of British Insurers, the Investment Management Association and the Association of Investment Companies.

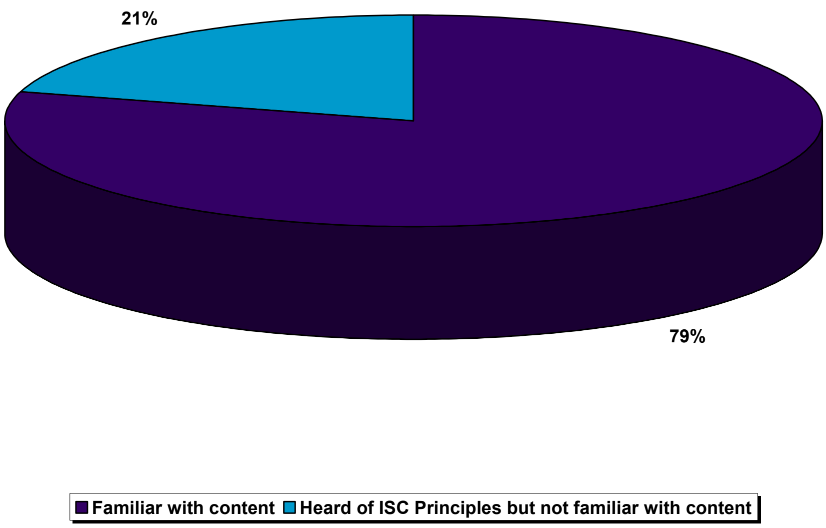
In a 2004 consultation document, HM Treasury suggested that pension fund trustees should comply with the ISC Principles[8].

Pension funds' familiarity with ISC Principles

Previous NAPF Shareholder Engagement Surveys showed that most large pension funds were aware of the ISC Statement of Principles. This year, for the first time, every respondent reported being aware of the Principles.

Almost 80% of funds in the sample (31 funds) were familiar with the content of the ISC Principles. The other eight funds had heard of the Statement of Principles but did not know the details of what it set out. Larger funds were most likely to say they have a good understanding of the Principles: the ten respondents with the most assets under management said they were familiar with the Principles' content, and 92% of assets covered by the Survey were held by funds giving this answer.

Figure 2: Pension funds' familiarity with ISC Principles



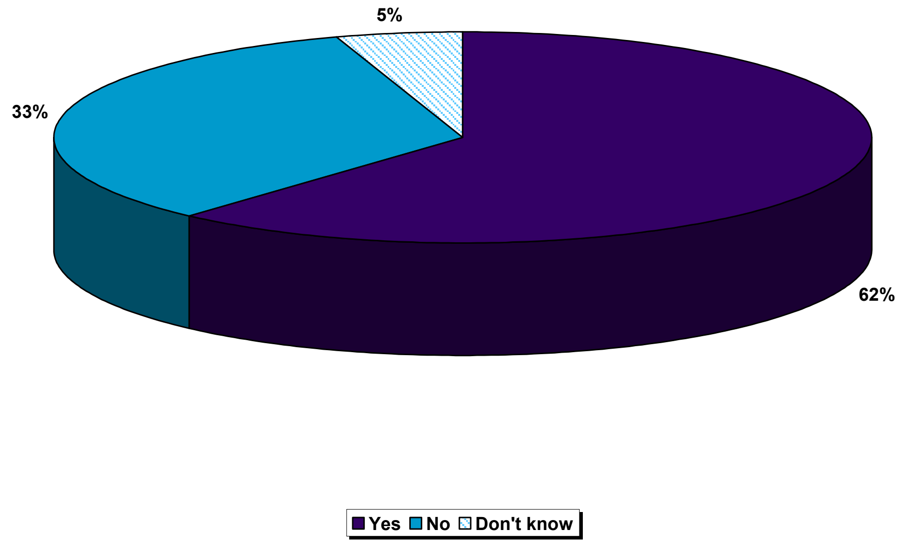
Base: All respondents (39 pension funds)

Implementation of ISC Principles

Almost two-thirds of respondents (24 funds) have incorporated the ISC Principles into their investment managers' contracts – either directly, or through a side letter, or by including them in the fund's own Statement of Investment Principles (SIP). A similar proportion of respondents to the 2006 Engagement Survey had incorporated the Principles into managers' contracts.

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

Figure 3: Incorporation of the ISC Principles into managers' contracts



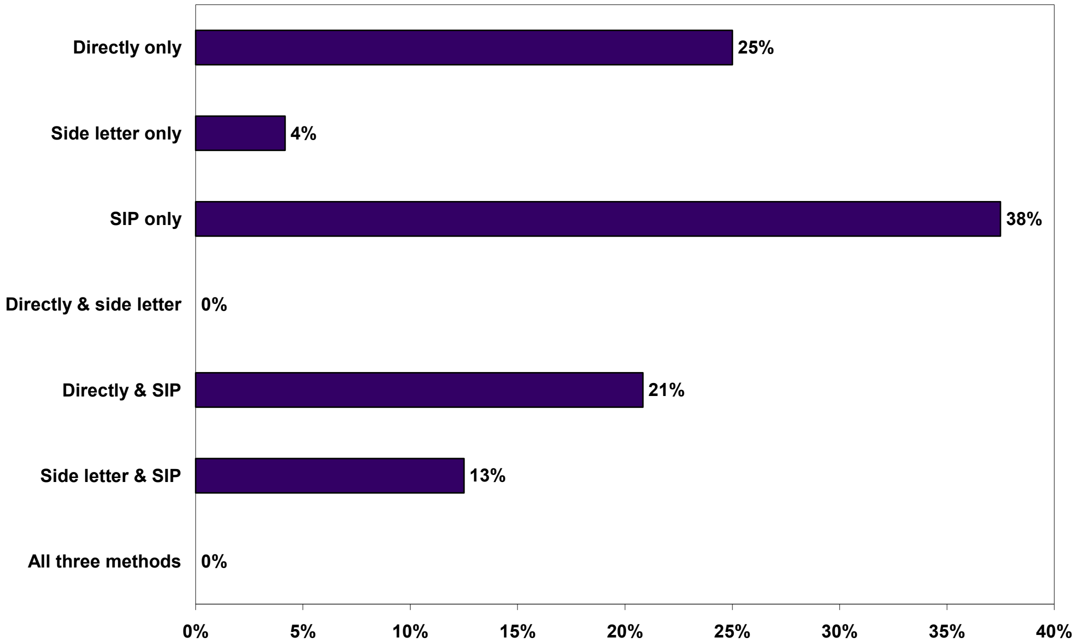
Base: All respondents (39 pension funds)

As well as being most likely to know what the ISC Statement of Principles says, the largest funds were also most likely to report that it had been incorporated into managers' contracts. 78% of assets covered by the survey were held by funds which had incorporated the ISC Principles into managers' contracts. The six respondents with the most assets had all done so.

How the ISC Principles have been incorporated into managers' contracts

Where funds have incorporated the ISC Principles into managers' contracts, the most common method of doing so is to include them in the fund's SIP, to which managers must have reference. 17 funds took this approach, including eight which also implemented the ISC Principles in other ways.

Figure 4: Methods by which the ISC Principles have been implemented



Base: All who had incorporated the ISC Principles into managers' contracts (24 pension funds)

Five of the six largest respondents have opted to implement the Statement of Principles by incorporating it into managers' contracts directly. In total, 11 respondents have incorporated the Principles into managers' contracts directly. Last year, ten respondents had taken this approach.

One fund reported that the Statement of Principles is incorporated directly into all new contracts, so the prevalence of this approach will increase over time as new contracts are signed. In the meantime, managers who signed contracts before this change must have regard to the fund's SIP, which refers to the ISC Principles.

Data collected by the Investment Management Association (IMA) also suggests that voting and engagement issues are featuring more regularly in agreements between agents and beneficial owners. By 2006, 24 out of 33 major fund managers surveyed by the IMA included their policy on voting in all new and existing agreements (up from 19 in 2004). Ten referred to their policies on the ISC Statement of Principles in both new and existing agreements (up from seven in 2004)[9].

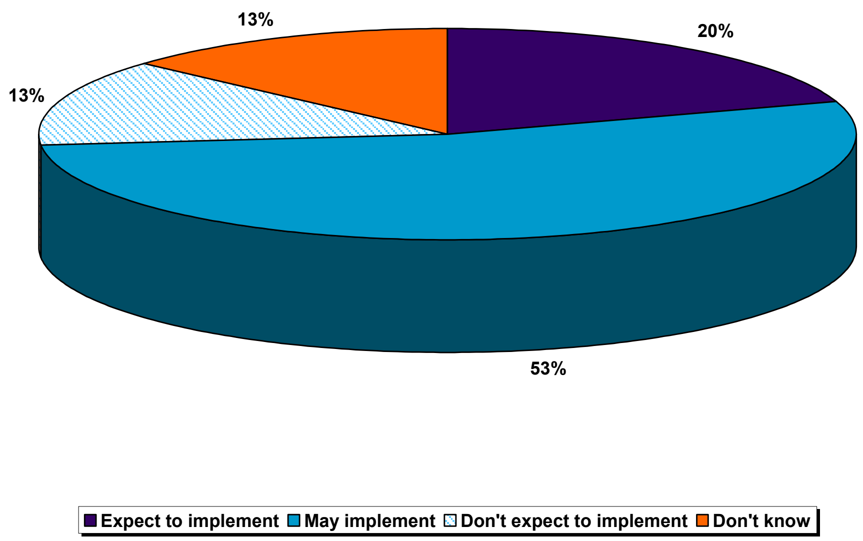
Will coverage widen?

15 respondents either had not incorporated the ISC Principles into managers' contracts or did not know whether this had been done. Only two of these say it is unlikely that they will implement the Principles during next two years. Most have no firm expectation that the Principles will be implemented but do not consider this unlikely.

9 *Survey of fund managers' engagement with companies for the year ended 30 June 2006*, IMA, July 2007, p7

Comparing these results with those published last year suggests that coverage of the Principles may be set to widen. Compared with 2006, funds which have yet to incorporate the Principles into managers' contracts were less likely to say they expected the Principles to remain unimplemented for at least two years (down from 30% to 13%). They were more likely to say they expect to implement the Principles (up from 10% to 20%).

Figure 5: Will you implement the ISC Principles in the next two years?

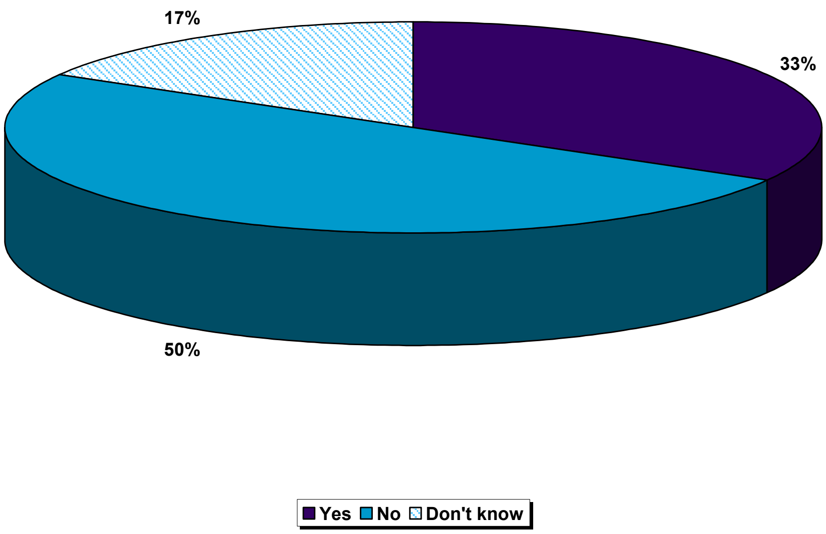


Base: All answering who had not incorporated the ISC Principles into managers' contracts or who did not know whether they had done so (15 pension funds)

The ISC Principles and pension funds' engagement activities

For many, it appears that adopting the ISC Principles is a way of formalising the good practices they were already developing and making it clear to investment managers that they expect these standards to be maintained going forward. Half of the funds which have implemented the ISC Principles say that doing so has not has made a difference to their engagement processes and policies.

Figure 6: Have the ISC Principles changed pension funds' engagement activities?



Base: All answering who had incorporated the ISC Principles into investment managers' contracts (24 pension funds)

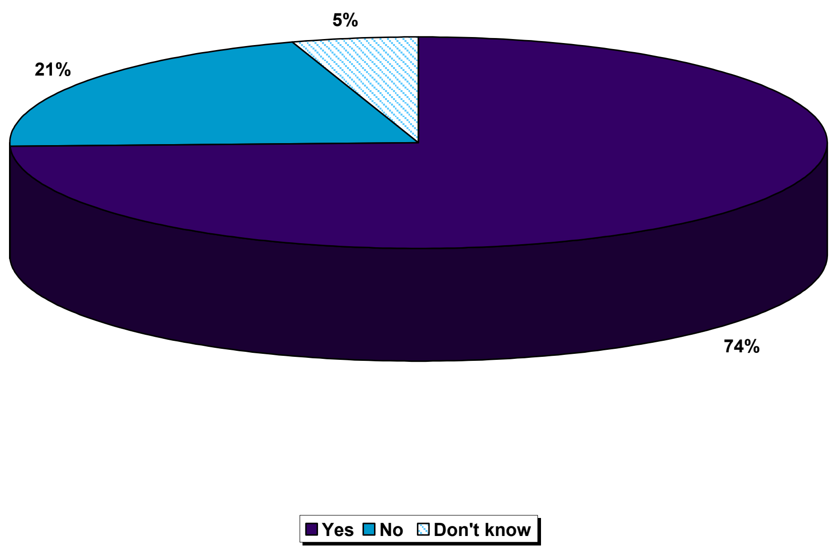
Pension funds' own engagement policies

Almost three-quarters of respondents (29 funds) have their own corporate governance, engagement or social responsibility policies. This is very similar to the result published in 2006.

The eight funds saying they do not have their own policy comprise a mixture of very large funds and smaller funds. Last year's NAPF Shareholder Engagement Survey recorded how some pension funds had taken the view that standardised corporate governance policies developed by specialists outside their own fund could help simplify the corporate governance landscape.

Of the 13 funds saying they have not incorporated the ISC Principles into managers' contracts, 11 have their own policy on corporate governance, engagement or social responsibility.

Figure 7: Pension funds' own corporate governance and engagement policies



Base: All respondents (39 pension funds)

The impact of engagement

Summary

- Pension funds' engagement is having an impact. Three quarters of funds have seen specific changes in investee companies after engaging with them. Most often, their engagement has helped to change directors' remuneration packages or the composition of the board of directors.

- Eight out of 10 funds say corporate governance standards in UK companies are improving. None believe these standards are deteriorating.

Changes delivered

More than three quarters of the sample (30 funds) have seen evidence that their voting and engagement activities are delivering specific, identifiable changes in investee companies.

Most often, these activities have helped reshape remuneration packages so that directors' incentives are more closely aligned with owners' interests. Changes to remuneration packages were reported by 29 funds, while 26 said their engagement had helped bring about changes in board membership.

More than half of respondents (22 funds) had seen evidence of their engagement leading to changes in company strategy. Respondents were slightly less likely to say that their engagement activities had led to changes in companies' social or environmental policies, with 20 funds seeing evidence of this.

Table 2: Impact of engagement

	Many times	Not many times but at least once	Never	Don't know
Board Membership	26%	41%	8%	26%
Company Strategy	26%	31%	13%	31%
Remuneration	36%	38%	5%	21%
Social/environmental policies	23%	28%	15%	33%

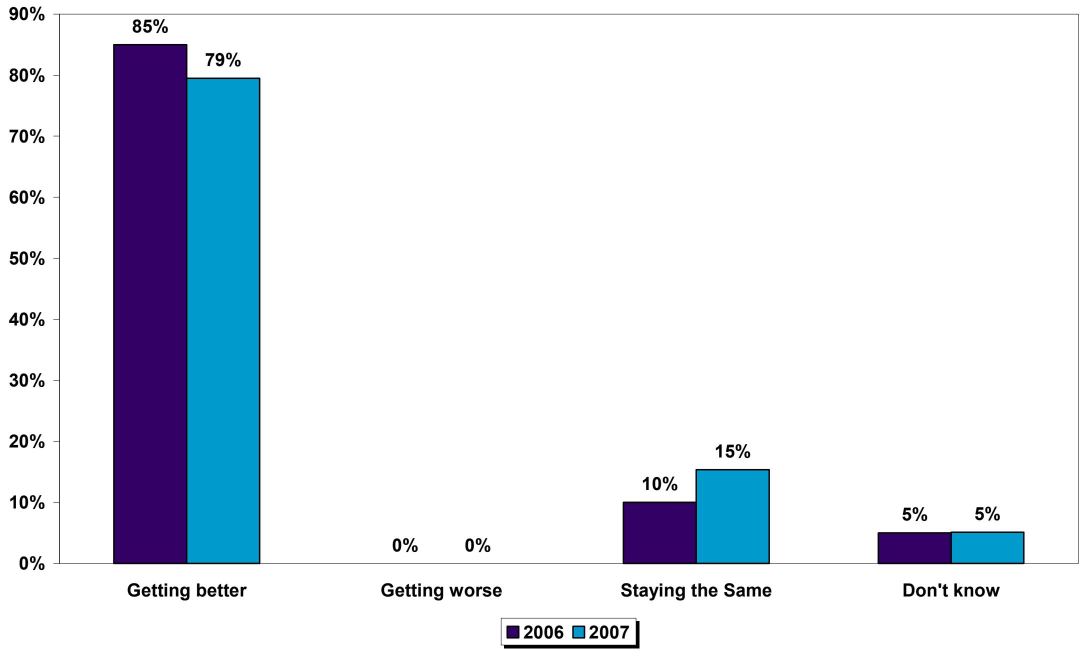
Base: All respondents (39 pension funds)

Data collected by NAPF for last year's Shareholder Engagement Survey suggested that the largest funds were more likely to have their own internal resources for engagement. Other things being equal, the largest funds will also possess the biggest shareholdings. Together, these factors may make it more likely that the benefits of effective engagement will exceed the costs, as well as making it easier to monitor the results that have been achieved. The three largest respondents all reported that they had on many occasions helped bring about changes in each of the four areas listed.

Perceptions of corporate governance standards

As well as observing specific improvements, the pension funds surveyed believe that governance standards in UK companies are getting better overall. For the second successive year, no respondants said corporate governance standards were deteriorating while around 80% believe they are continuing to improve.

Figure 8: Perceptions of corporate governance standards



Base: All respondents (39 pension funds in 2007, 41 pension funds in 2006)

If this perception is well-founded, all investors (including private individuals) will benefit from the steps pension funds and other institutional investors are taking to improve governance standards in Britain's boardrooms.

Agents and engagement

Summary

- Pension funds are demanding regular and comprehensive reports from agents who exercise voting rights or carry out wider engagement activities on their behalf. Managers' reports are on average submitted at least twice a year.

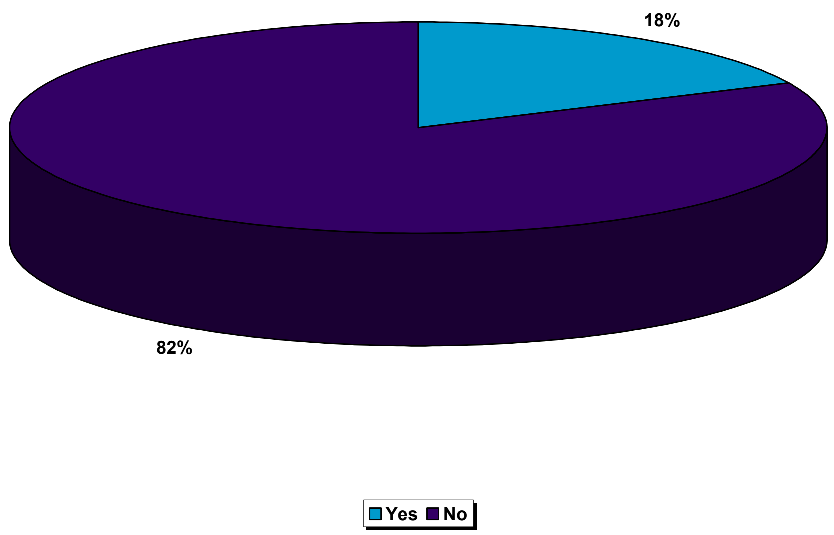
- Large majorities of funds say managers have informed them about votes against company management, votes not cast and departures from the manager's usual voting policy. Virtually all funds expect to be informed of these developments when they arise.

- Less than half of the funds surveyed say they do not believe their attitude to engagement will influence their selection of managers in the future.

Outsourcing engagement

Seven respondents say their engagement activities have been wholly or partly outsourced to a specialist engagement service. Hermes and Governance for Owners were named as specialists to whom engagement activities had been outsourced.

Figure 9: Do you outsource to a specialist engagement service?



Base: All respondents (39 pension funds)

For most of the remainder, at least some engagement activities in addition to voting will be carried out on their behalf by investment managers.

Managers' reports

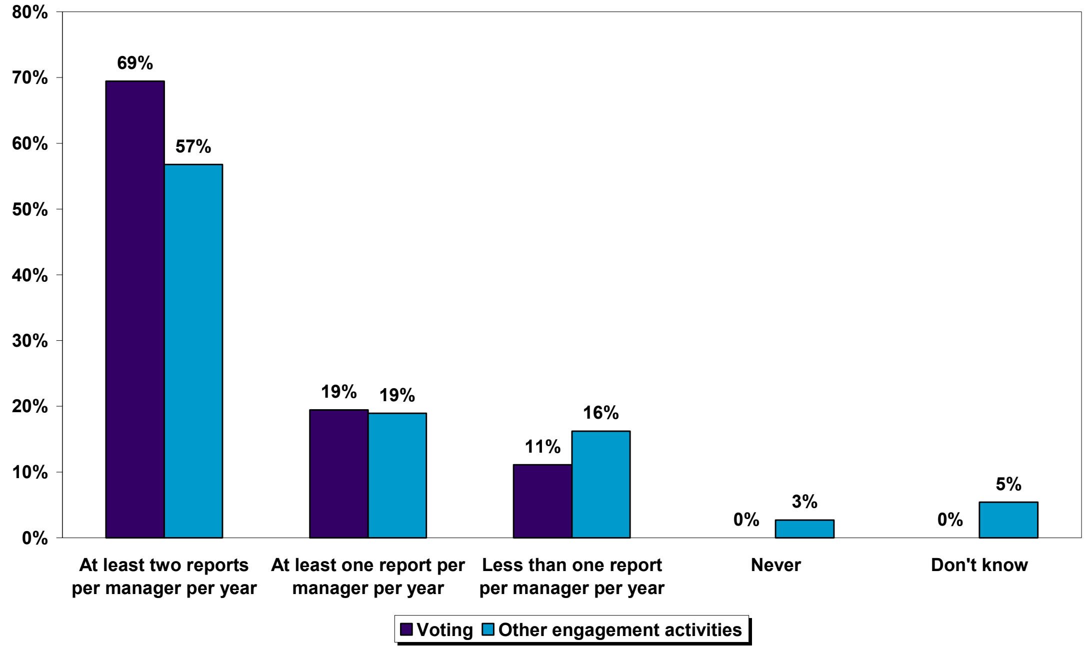
The ISC Principles say that agents should report back to the beneficial owners on the impact of their engagement activities. This survey suggests that pension funds are asking managers for reports that are both regular and comprehensive.

Regularity of reports

Amongst respondents whose managers cast votes for them, two thirds (25 funds) say that their managers will, on average, submit reports on voting at least twice a year. Most of the remainder receive at least one report per manager per year on voting.

When it comes to wider engagement activities, a majority of funds receive an average of at least two reports per manager each year.

Figure 10: Frequency of managers' reports on voting and engagement[10]



Base: All respondents, excluding those who say that all voting/engagement is done centrally rather than through managers (36 pension funds for voting; 37 pension funds for other engagement activities)

Content of reports

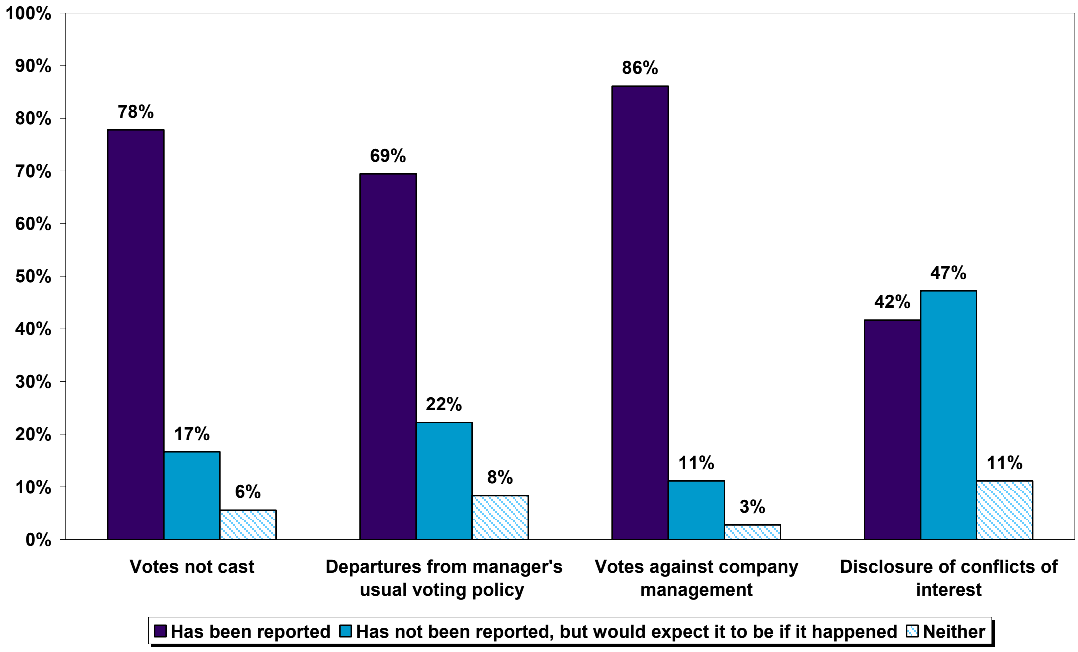
Virtually all respondents who receive reports from their fund managers expect these to cover:

- votes cast against company management;
- votes not cast;
- departures from the manager's usual voting policy; and
- any conflicts of interest.

10 Schemes which outsource engagement activities to a specialist service may have answered this question in different ways. Some may have included reports from these specialists while others may have answered only about the reports received from managers.

The first three issues have all featured in the reports received by a majority of respondents. Almost half say their managers have had occasion to disclose conflicts of interest.

Figure 11: What do reports include?[11]



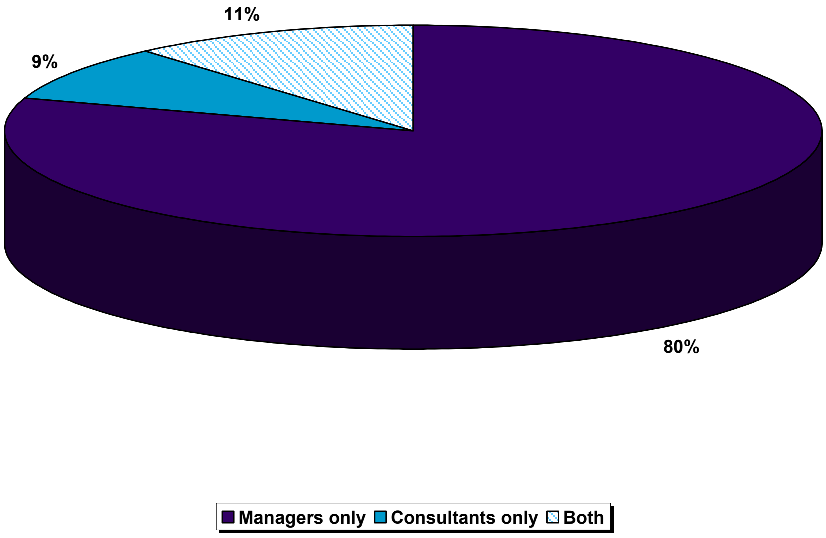
Base: All respondents, excluding three who handle voting internally (36 pension funds)

The form reports take

Most funds receive reports on voting and engagement only from managers. Seven respondents receive reports from consultants as part of a consolidated report which will either supplement or replace managers' reports. Last year's Shareholder Engagement Survey found that no funds relied solely on oral updates from their managers, with the majority receiving a combination of written reports and oral reports.

11 Includes data from one scheme who gets a full report from Hermes Equity Ownership Services rather than managers

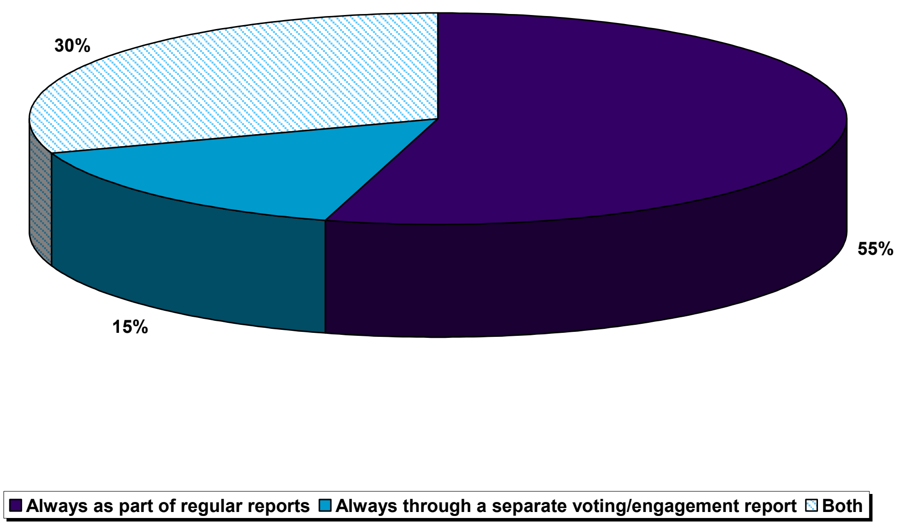
Figure 12: Who do reports come from?



Base: All respondents excluding two which handle all voting and engagement internally and two not answering (35 pension funds)

Just over half of the funds which receive reports from managers directly say this information always comes as part of the manager's regular investment report. 15 funds receive separate updates on voting or engagement from their managers.

Figure 13: How do managers present reports?



Base: All respondents, except those where no voting is undertaken by managers, those whose reports came only from consultants, and those not answering (33 pension funds)

Vote audits

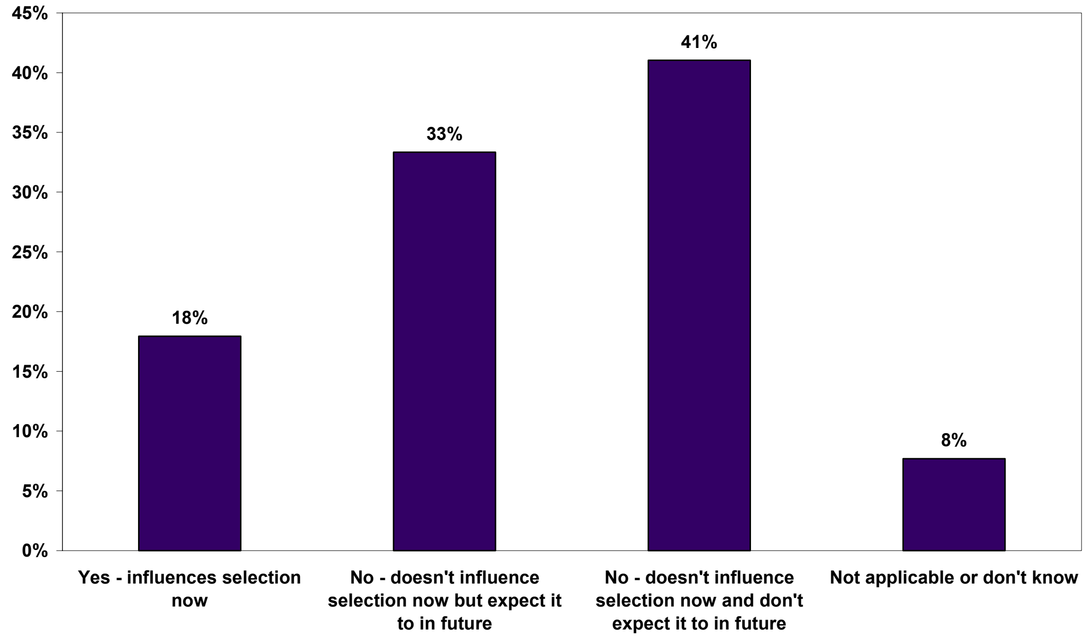
Five respondents had asked managers for an audit of votes actually cast. Four of these reported that such audits had occasionally (but not usually) revealed "lost" votes which, for whatever reason, had not been lodged with the registrar in accordance with instructions. The other fund to have commissioned audits from its managers said no lost votes had been revealed.

A study by Georgeson Shareholder found that 5% of the votes that could have been cast by large institutional investors at one FTSE100 AGM were lost. In his July 2007 report to the Shareholder Working Group – published after the fieldwork for this survey was undertaken – Paul Myners recommended that pension funds take steps to ensure their voting instructions are translated into practice and that they encourage their custodians to facilitate tracing exercises[12].

Engagement and manager selection

For the second successive year, the proportion of respondents saying they expect their attitude to engagement will not influence the selection of investment managers in future has fallen. 41% of respondents (16 funds) now have this expectation, down from 53% in 2006 and 56% in 2004[13]. Some funds may give this answer simply because they have found little differentiation on engagement between the managers who they would consider employing based on other considerations.

Figure 14: Does a fund's attitude to engagement influence manager selection?[14]



Base: All respondents (39 pension funds)

12 Review of the impediments to voting UK shares, July 2007

13 The question used in 2004 was slightly different.

14 Respondents listed under "not applicable/don't know" include one who employs investment managers internally and one who has outsourced their engagement activities to a specialist service rather than asking fund managers to carry out this role.

Resources for engagement

Summary

- Nearly half of the funds surveyed say the resources devoted to engagement by them and their manager have increased since 2001. One third say these resources have increased since 2005, and none say resources for engagement have fallen over this period.

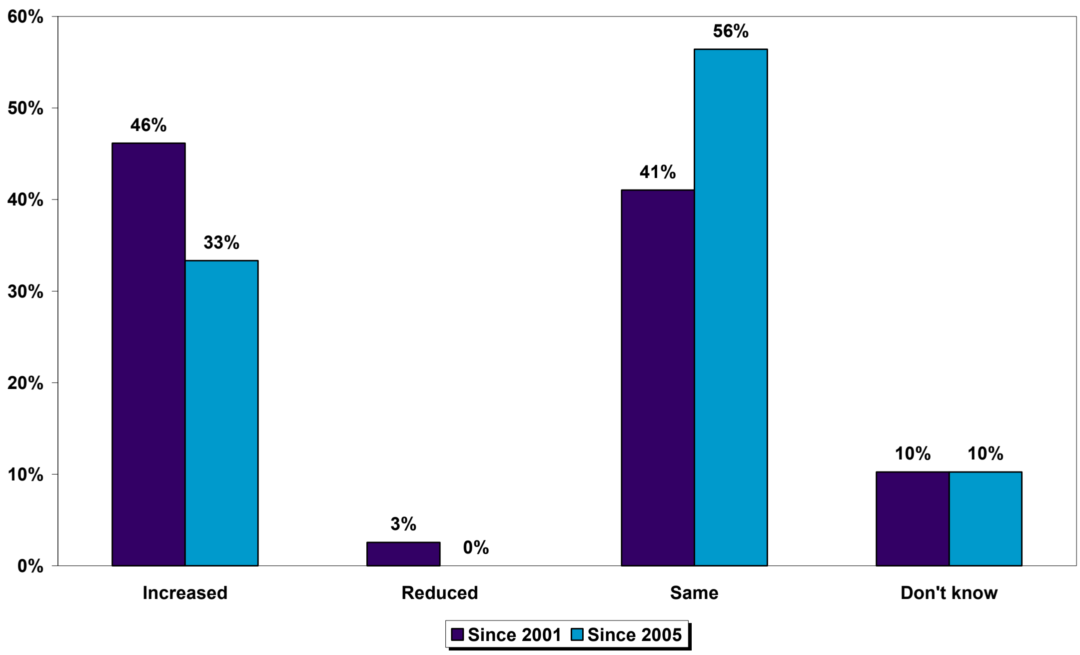
- More than one third of respondents subscribe to voting reference agencies, with very large funds most likely to do so. These recommendations are scrutinised and most funds have at some stage rejected an agency's recommendation.

The ISC Statement of Principles recognises that dealing effectively with concerns about company underperformance may require resources to be committed. It emphasises that the resources used by shareholders or their agents in pursuit of this objective "should be commensurate with the benefits for beneficiaries".

Perceptions of increased resources

18 funds say that, taking their efforts and managers' efforts together, the level of resources devoted to engagement has increased since 2001. Only one says it has fallen[15]. 13 funds report that resources for engagement have risen not only since 2001 but also since 2005. A mixture of very large funds and smaller funds say this has happened.

Figure 15: Resources for engagement



Base: All respondents (39 pension funds)

15 The scheme reporting a reduction in resources devoted to engagement invests a smaller than average share of its assets in UK equities,

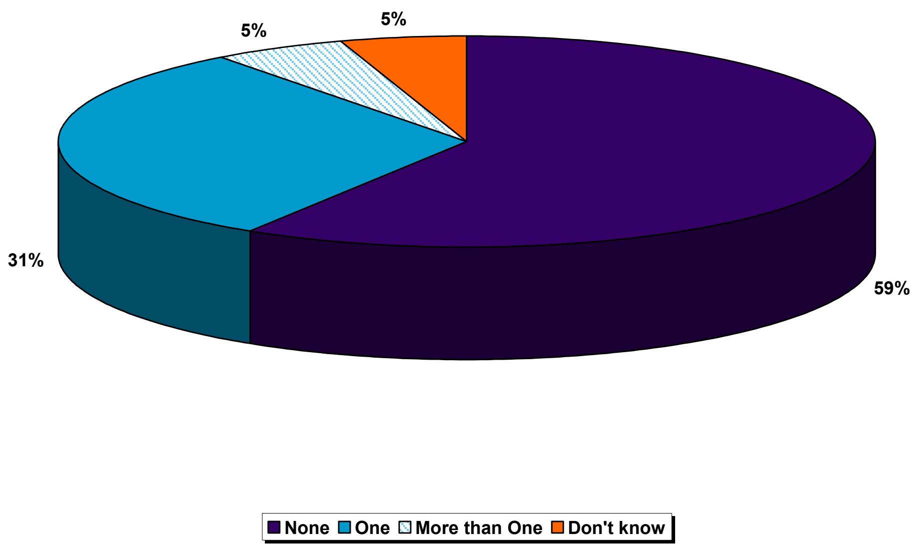
Data from the IMA suggests that the number of people employed on voting, engagement and Socially Responsible Investment by leading fund managers increased by 28% during the three years to June 2006[16].

Voting reference agencies

14 of the funds surveyed subscribe to voting reference agencies, including two funds which subscribe to more than one voting reference agency. Some of the funds which do not subscribe to voting reference agencies themselves will use fund managers or engagement specialists which receive an agency's recommendations[17].

The largest funds were most likely to subscribe to voting reference agencies, with six out of the nine biggest saying they do. Subscribers account for 45% of all assets in the sample.

Figure 16: Use of voting reference agencies



Base: All respondents (39 pension funds)

The agencies most often subscribed to were RREV/ISS, which uses the NAPF's corporate governance policy (nine funds), and PIRC (five funds). Other reference agencies used by respondents were Manifest and Glass Lewis.

Of the 14 funds which subscribe to voting reference agencies, eight had at some stage chosen not to follow the agency's recommendation. Explanations for these decisions included:

16 Survey of fund managers' engagement with companies for the year ended 30 June 2006, Investment Management Association, July 2007, p10

17 Three funds not subscribing to a reference agency themselves outsourced their engagement activities to specialists such as Hermes. One fund which did not subscribe to an agency itself mentioned that its fund manager subscribed to Manifest.

- in-house analysis of the issues (six respondents);
- meeting the company directly (two respondents);
- receipt of conflicting advice from the fund manager (two respondents); and
- receipt of a conflicting recommendation from another agency (one respondent).

Voting

Summary

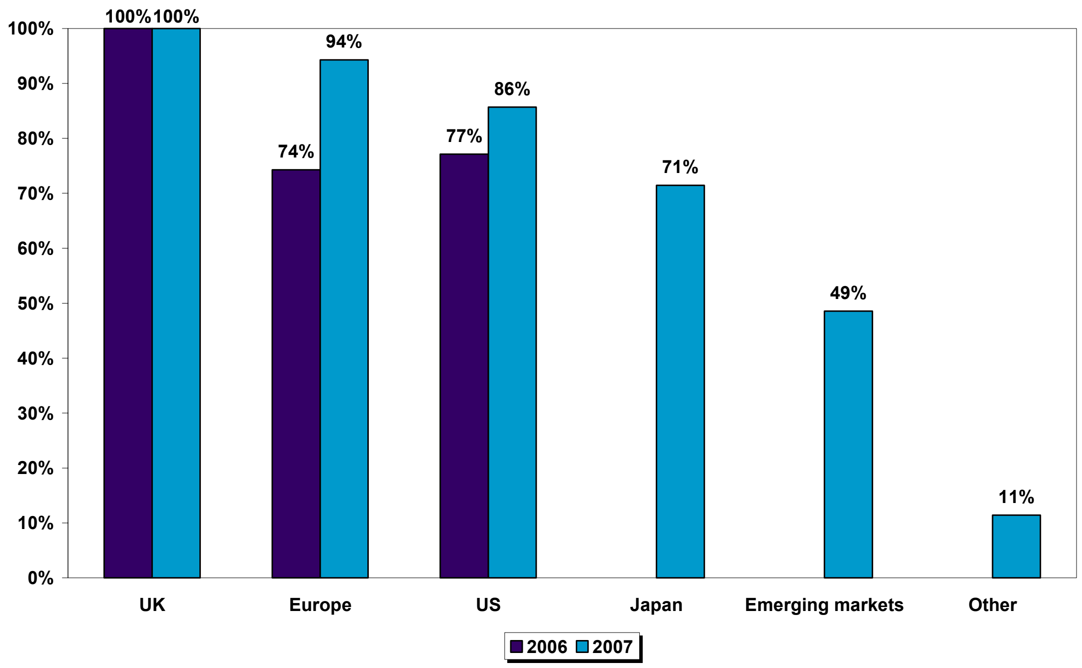
- It is the norm for large pension funds to vote in the US, Japan and at least some European markets, as well as in the UK.
- Most funds which lend stock recall it for contentious resolutions.
- As well as setting out their general voting policy in a public document, one third of funds surveyed disclose details of how specific votes have been cast at company meetings.

Voting by market

Our 2006 Shareholder Engagement Survey found that all funds which vote their own shares or liaise with managers about voting cast votes at UK company meetings. The evidence this year is that more funds are exercising their voting rights overseas. Big majorities vote in Europe[18], the US and Japan, while almost half cast votes attached to stocks listed on emerging market exchanges.

In 2006, less than half of pension funds surveyed voted in any market besides the UK, US and Europe. By 2007, more than three quarters did so[19].

Figure 17: Markets in which votes are cast



18 The survey asked only whether pension funds vote in Europe, not which European markets they vote in. Some funds may vote in some European markets but not in others. Figure 17 should not therefore be taken to mean that a share in a European company is more likely to be voted than a share in a US company.

19 The 2006 questionnaire had a single category for votes cast in markets other than the UK, US and Europe. The 2007 questionnaire asked separately about Japan, emerging markets and other markets.

Base: All answering who vote their shares themselves or liaise with fund managers on voting (35 pension funds in each year)

Stock lending

More than half of the funds surveyed (23 funds, including the ten largest funds in the sample), lend stock. Most of these (14 funds) said they recall stock for contentious votes – something which the July 2007 report to the Shareholder Working Group from Paul Myners says that pension funds should consider doing[20].

In total, more than 70% of funds surveyed either do not lend stock or recall it in order to vote on contentious resolutions. An almost identical result was obtained in 2006.

Voting disclosure

Under the ISC Statement of Principles, institutional shareholders and their agents should issue a public document setting out how they will discharge their responsibilities. This should cover their policy on voting.

In June 2007, the ISC published a framework on voting disclosure, which recognised the interest in this subject. This framework is reproduced in full at Appendix 3.

Box 2: The ISC framework for voting disclosure

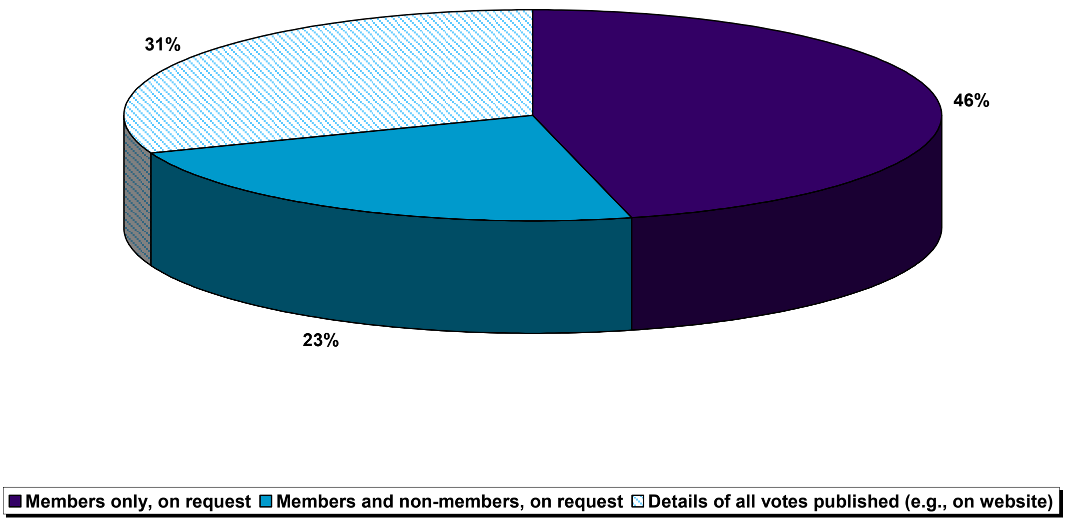
- The ISC supports a voluntary approach to voting disclosure which takes account of institutional shareholders' fiduciary obligation to act in the interests of beneficiaries.
- Voluntary public disclosure is generally desirable but may not be appropriate in all cases. Shareholders and agents should provide reasoned explanations if they decide not to disclose either as a general policy or in a specific case.
- The precise method of voting disclosure is a matter for each institution: some may choose to disclose how each individual vote was cast; others may publish details of specific votes only when they have departed from their general voting policy.
- Information need only be disclosed once. Where voting is delegated, representatives of beneficial owners need not replicate disclosures made by the fund manager. Fund managers will require authorisation before making disclosures.
- Given the complexity of the voting chain, disclosures will usually relate to voting instructions.
- Voting disclosure must not jeopardise the creation of value through engagement with investee companies. A time lag between the general meeting and the publication of information is appropriate and may reduce the risk of inappropriate pressure from interest groups whose objectives are not aligned with beneficiaries' interests.

20 Review of the impediments to voting UK shares, July 2007

The ISC noted that public disclosure of votes is becoming increasingly common, with disclosures now being made in respect of £340 billion of UK equities managed by UK institutional investors.

13 of the funds surveyed – one third of the total – disclose how specific votes have been cast at company meetings as well as setting out their stance on voting in a policy document. Seven of these disclose how votes are cast to the public as well as to scheme members. The two largest funds in the sample both publish details of all votes cast.

Figure 18: To whom are votes disclosed?



Base: All respondents who disclose how votes have been cast (13 pension funds)

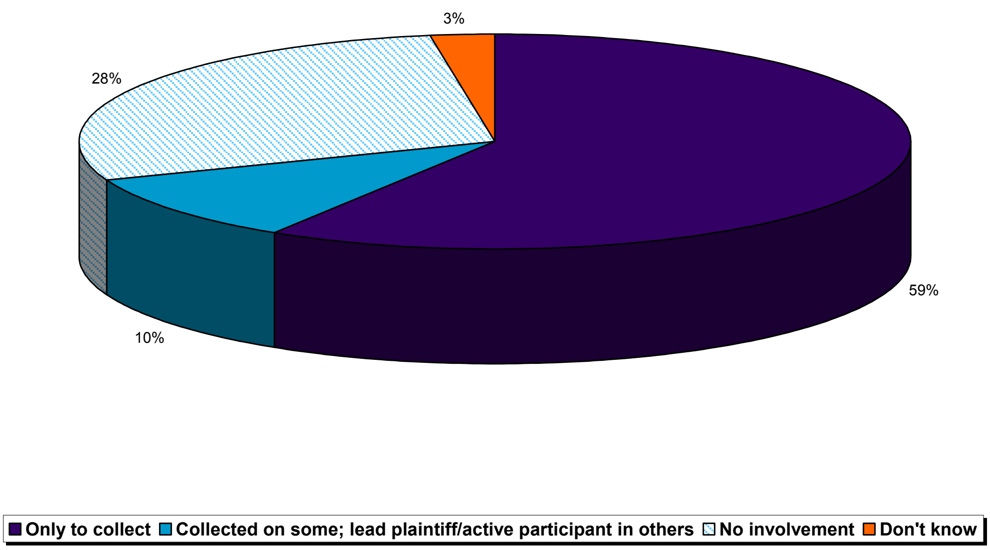
Disclosure will frequently come via agents. The ISC reports that 16 major fund managers are now making public disclosures, up from two in 2002.

Class actions

Class actions can enable investors to recover losses incurred owing to an act of fraud or to change corporate governance practices. In 2006 $18.3 billion was paid out by US companies under class action settlements, Institutional Shareholder Services estimate. Following suggestions that some $2.4 billion remains unclaimed by UK and European investors, the NAPF published a guide to help trustees ensure their funds were not missing out on significant sums[21].

More than two-thirds of respondents reported having had some involvement with class action settlements (27 funds). In most cases, this involvement was limited to collecting on a settlement after a law suit initiated by other investors had been settled. However, four funds had also acted as a lead plaintiff/active participant.

Figure 19: Pension funds' involvement with class action settlements



Base: All respondents (39 pension funds)

21 Securities Litigation – Questions for Trustees, NAPF March 2007

Appendix 1: A note on presenting the results

When interpreting the findings of this survey, the following points should be kept in mind:

- For simplicity, the graphs in this report express results as percentages. However, the small sample involved means that a single respondent can account for almost three percentage points in most cases and sometimes for more than that. The main body of the text frequently indicates the actual number of respondents giving a specific answer.

- Not all questions were relevant to every pension fund. The number of responses and the base for percentage calculations therefore varies between questions.

- Some comparisons with the 2006 Shareholder Engagement Survey are included. However, the small sample size for both surveys means some of the changes reported could easily be explained by differences in the sample.

Appendix 2: 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[22]. 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 shareholders and agents should keep under review how far the principles in this statement can be applied to other equity investments.

22 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.

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.

Appendix 3: The ISC framework for voting disclosure

The Institutional Shareholders' Committee (ISC) recognises the interest in the disclosure of information on voting and that such disclosure is becoming increasingly common.

The ultimate responsibility for voting rests with the beneficial owners of shares or their delegated representatives, for example, trustees of defined benefit pension schemes or boards of investment trusts. It is therefore the beneficial owners, and their representatives, rather than the fund managers who act as their agents, who should decide on their voting disclosure policy.

However, it is common practice for the beneficial owners or their representatives to delegate voting to their fund managers. Where fund managers are acting as agents in this way, they will require authorisation before making disclosures.

Fund managers already follow the ISC recommendation that they should disclose their voting decisions to wholesale clients. It is also best practice for them to disclose to retail clients and beneficiaries if the information is requested.

As regards making information on voting public, the ISC supports a voluntary approach which takes account of the overarching fiduciary obligation of institutional shareholders and their agents to act in the interests of beneficiaries. This allows them to take a considered view of the benefits of disclosure and gives them flexibility so that any disclosure made can be tailored to suit the needs of their stakeholders and be achieved without excessive cost and compliance burdens. Institutional shareholders or their agents who have chosen to disclose publicly may perceive benefits including an improved understanding by retail customers and beneficiaries of institutions' stewardship of their investments.

On this basis, voluntary public disclosure is generally desirable, although it may not be appropriate in all cases. For instance, where institutional shareholders or their agents have a policy to disclose, they should provide explanations of any exceptions where they consider disclosure to be inappropriate. Where their overall approach is not to disclose, the ISC recommends that they provide a reasoned explanation of that policy.

The current situation

Significant levels of disclosure are now being made. Public disclosure of votes is now being made in respect of £340 billion of UK equities managed by UK institutional investors. This includes disclosures by 16 major fund managers. The ISC is aware that other institutions are also considering disclosure and anticipates that further disclosure will be made on a voluntary basis in due course. (This compares with 30th June 2002 when only 2 institutions were making public disclosures.)

Overseas investors, who may not normally disclose voting decisions, represent an increasing proportion of UK equity ownership.

Developing and publishing a policy on disclosure

This framework should be read in conjunction with the ISC's Statement of Principles on the Responsibilities of Institutional Shareholders and Agents. The 'Statement of Principles', first published in 2002 and subsequently updated, refers to public disclosure of votes. It says that institutional shareholders and their agents should have a published policy on engagement with investee companies, which should include reference to their policy on public disclosure of votes. This policy should be published and regularly reviewed.

Method of disclosure

The most cost effective method of disclosure will normally involve publishing voting information on a website, which is accessible to the public.

This framework is not intended to be prescriptive and institutional shareholders and their agents have significant flexibility to determine how they approach this matter. For example, Institutions may choose only to publish details of individual votes where they have departed from their published voting policy. Alternatively, institutions may choose to disclose their voting on each and every vote. The precise method of public disclosure is a matter for each institution.

Also, given the complexity of the voting chain, it is likely that any disclosure made will relate to voting instructions given rather than votes actually cast. In addition, disclosing voting instructions may make it easier to justify disclosure on a cost benefit basis. It is reasonable for those viewing disclosures of voting instructions to assume that, where a poll was taken, the votes were counted as intended.

The ISC believes voting disclosure must not jeopardise the creation of value through engagement with investee companies. With this in mind, it is appropriate that disclosure should take place only after the relevant general meeting and a time lag in publishing information on voting will be appropriate. This may also reduce risks of inappropriate pressure from special interest groups whose objectives are not aligned with those of clients and/or beneficiaries.

What is disclosed

Information on voting need only be disclosed once. Where voting is delegated representatives of beneficial owners need not replicate disclosures made by the fund manager, or other third party, unless they choose to override them.

Where fund managers offer several different products to their clients it should be sufficient for fund managers to make aggregate disclosure of voting instructions given according to the issuer of the shares without specifying the clients whose shares they have voted, the number of shares in respect of which instructions were given, or the product/scheme that holds the related shares. Such disclosures will give a clear picture of the institution's policy. This approach may reduce the potential problems in relation to their fiduciary duties and reduce costs while still giving a clear picture of its approach to the issues on which votes are sought.

Review of disclosure policy

Institutional investors should review their policy on voting disclosure on a regular basis. The ISC anticipates that this would be done as part of the wider review of the policy on engagement.

ISC member associations will monitor progress under this framework and report back to their members.

Securing the future of pensions

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