NAPF

Securing the future of pensions

Revision of the Shareholder Rights Directive – an NAPF briefing

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Overview

The National Association of Pension Funds (NAPF) is the voice of workplace pensions in the UK. We speak for over 1,300 pension schemes that provide pensions for over 17 million people and have more than £900 billion of assets. We also have 400 members from businesses supporting the pensions sector.

We aim to help everyone get more out of their retirement savings. To do this we promote policies that add value for savers, challenge regulation where it adds more cost than benefit and spread best practice among our members.

- We support the objectives of these proposals, namely to further encourage and better facilitate effective long-term shareholder engagement with investee companies across borders. An engaged shareholder base alongside high standards of governance, transparency and protection of minority shareholder rights should enhance the attractiveness of the EU market for both investors and issuers, and so play a role in driving economic growth across Europe.

- With our members invested in companies across the European Union, the enhancement of important shareholder rights over issues such as related party transactions and executive remuneration is welcome, providing important protection for minority shareholders and facilitating investors' stewardship efforts. By giving investors greater confidence that their assets will not be expropriated, investor confidence will be boosted and investment increased. The reduced cost of capital for European companies will be positive for broad-based economic growth.

- We agree that it is crucial asset owners are equipped with sufficient information that they can foster a truer market amongst asset managers and are able to hold their investment managers more accountable for the appropriate stewardship of their assets in the interests of underlying beneficiaries.

- It is also right that, as principals, pension funds develop and disclose an investment policy which includes an understanding of their objectives and risks and clearly sets out their expectations to their agents with respect to activities such as engagement and voting. A balance, however, needs to be struck between encouraging the right behaviours whilst avoiding introducing overly prescriptive measures which risk creating a compliance tick-box exercise with boiler-plate disclosures.

➢ There are important elements of the Directive which warrant *strengthening* such as in relation to the extension of shareholders rights over related party transactions.

➢ There are also elements of the Directive which should be *reviewed* in order to ensure that the requirements most effectively deliver the underlying objectives. In particular, article 3g should appropriately account for the differences between pension funds and insurance companies and resultant disclosure requirements should be set within the context of fund's wider funds' strategic investment approach which will be linked to the nature of its liabilities. The aim should be to encourage active consideration by the trustee board of how it assesses and manages financial and non-financial risks and approaches its stewardship responsibilities.

Individual elements

Chapter IB - Transparency of institutional investors, asset managers and proxy advisors

Article 3f - "Engagement policy"

- The NAPF is supportive of efforts to encourage a more long-term mindset amongst investors and most pertinently enhance the level of transparency around how different investors approach stewardship activities. However, in introducing disclosure requirements via this Directive, care should be taken to avoid creating a compliance approach at the expense of encouraging the right behaviours.

- The UK Stewardship Code – operated on a comply-or-explain basis - has been very significant in improving both the quantity and quality of engagement between institutional investors and their investee companies. Efforts to translate these principles across the European Union are welcome.

- The NAPF surveys its largest pension fund members each year with respect to their engagement with investee companies. The results clearly demonstrate[1] that there is a near consensus amongst pension funds that they have stewardship responsibilities which include engaging with companies and voting.

- In the UK asset managers are required through regulation to comply or explain against the UK Stewardship Code. With respect to asset owners the Code explains that while they may (and commonly do) delegate the activities associated with stewardship to their asset managers they retain a responsibility for monitoring these undertakings.

- The number of asset owner signatories to the UK Stewardship Code continues to increase year on year – there are now 82 asset owner signatories including 63 pension funds. Additionally a number of large pension funds which have in-house asset management arms are signed-up as one-client asset managers. The NAPF has long believed that a greater weight of pension fund signatories to the Code is important to give a clear signal to the market and in turn influence behavioural changes that lead to better stewardship by asset managers and companies.

- It is encouraging that several member states, and indeed countries internationally, have introduced their own versions of the Stewardship Code in recent years. Whilst we support a legislative underpin we would caution against too much prescription being set out within statute and instead encourage an approach whereby Member States introduce their own Codes that can be more readily changed to reflect developments over time.

- Given that UK pension funds recognise that they have stewardship responsibilities we are supportive of the proposals to require both institutional investors and asset managers to develop an "engagement policy". Indeed, in the UK, the government will shortly consult on amending the Occupational Pension Scheme (Investment) Regulations to require trustees of trust-based pension schemes to state the scheme's policy (if any) on stewardship in the scheme's Statement of Investment Principles. This is a change which the NAPF has been active in calling for.

[1] NAPF 2014 Engagement Survey

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- We believe that consideration should be given to the differences between pension funds and insurance companies when determining to whom such disclosures should be made. In particular, given that pension funds are not-for-profit and non-competitive entities which are generally run by fiduciaries this disclosure should primarily be directed towards their members and beneficiaries. Where however, an institutional investor is marketing themselves within the market-place then such disclosures should be made public.

- On transparency of voting, it is established good practice that institutional investors disclose their voting policies, process and decisions. We support efforts to standardise these disclosures in order to encourage greater and more considered exercising of voting rights. It is important that explanations are provided for "significant" votes – both for and against management and in particular with respect to M&A resolutions.

- We empathise with the objective of encouraging better disclosure of engagement activities as best practice is evolving in this direction. More asset managers are now willing to provide greater and richer reporting of their activities on behalf of their clients which is positive. However, any specific requirements need to be balanced against the need for conversations between investors and companies to continue to be able to take place privately and confidentially.

Article 3g - Investment strategy of institutional investors and arrangements with asset managers

- The NAPF empathises with the objectives of this article; however, we feel that it in places strikes too prescriptive an approach and thus risks failing to see the wood for the trees.

- We believe that the desired policy objectives and in turn behavioural changes can most effectively be achieved by requiring pension funds and other asset owners to develop, publish and regularly update a set of investment principles and set out how these principles are enacted.

- These publicly disclosed investment principles would need to remain sufficiently high-level to cater for practical arrangements, but should cover:

  - How the investment strategy as a whole seeks to finance the pensions obligations due to beneficiaries;

  - The fund's approach to short-term volatility – this would include the approach to turnover and how this is balanced with the need to maintain stability through appropriate diversification;

  - The approach to understanding, managing and mitigating risk - this would include the fund's approach to managing and taking advantage of both financial and non-financial risks looking out over an appropriate time horizon;

  - The time horizons against which absolute investment performance is judged – this would include how different risks are assessed and the resultant implications for the investment strategy;

  - The governance arrangements around investment decision making and how expectations are communicated to their agents – this would include the oversight of stewardship activities including with respect to the rights attached to individual investments.

- We believe it important that for pension funds (IORPs) this article should be aiming to encourage trustee boards to think through and debate their investment beliefs and set out resultant principles within the context of their overall investment approach and their liabilities. Disclosures would cover the funds

approach to managing all financially material risks over an appropriate time horizon and alongside their stewardship philosophy – in particular how they will oversee and hold accountable those to whom they delegate particular functions.

- Pension funds generally have long-term investment horizons and are often thought of as universal owners – long-term owners of a diversified investment portfolio that is spread across the entire market or markets. As a result, there is a necessity for pension funds to manage longer term risks through asset allocations and active ownership practices that are sensitive to longer term factors. As confirmed by the UK Law Commission in July 2014 appropriate consideration of risks should include all financially material risks; thus when investing in equities over the long-term, trustees are expected to consider how to assess risks - this includes risks to a company's long-term sustainability.

- A pension fund's investment strategy encompasses much more than investment in listed equities, indeed the equity element in many cases constitutes a diminishing proportion of the scheme's investments - as of 2013 UK defined-benefit pension funds had only 30% of their assets invested in listed equities with a further 37% in fixed income assets such as UK gilts, overseas government bonds and corporate bonds, alongside further investments in property, infrastructure and other investments. Given this context, consideration should be given to existing disclosure requirements set out within the IORP Directive any additional requirements be mindful of the nature of pension fund portfolios.

- The vast majority of pension funds outsource the management of their investments to multiple asset managers. In these circumstances it is essential that the principal-agent relationship is governed in the interests of beneficiaries. It is right that pension funds should provide effective oversight of their managers, essentially holding accountable those who are calling others to account on their behalf.

- In the context therefore of a holistic pension fund investment strategy it is unclear what value is achieved for members and beneficiaries through some of the more prescriptive elements of the proposed requirements; these risk boiler-plate disclosures instead of meaningful discussion and behavioural change. It would also be wholly inappropriate to expect disclosure of specific contractual arrangements between two private parties.

- The results from the NAPF's 2014 Engagement Survey suggest that funds are increasingly selecting asset managers based upon their stewardship capabilities and subsequently holding them more accountable:

  - 80% of respondents indicated that they take the stewardship activities and policies of managers into account when selecting managers. For many funds this goes beyond simply requiring managers to be a PRI signatory with over 60% actively questioning prospective managers about their approach.

  - More than half of respondents are asking more questions on stewardship matters during manager reviews; additionally more time is spent reviewing reporting and votes cast.

- The NAPF Stewardship Disclosure Framework enables pension funds to easily compare and contrast the stewardship approaches of different asset managers. Furthermore, the NAPF's recently launched Stewardship Accountability Forums enable pension funds of all sizes the opportunity to collectively question the senior figures within large asset managers and ultimately press them for the highest standards of stewardship in the interests of their members and beneficiaries.

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Article 3h - Investment strategy of institutional investors and arrangements with asset managers

- It is crucially important that asset managers provide detailed reporting to their clients explaining clearly how they have sought to enhance and protect value for their client.
- Client reporting should enable pension funds to understand the *what*, *why* and *how* with respect to the activities of their investment manager. In turn this will foster a more constructive relationship in which both parties share the objective of achieving long-term sustainable investment returns in the interests of the underlying beneficiaries.
- Importantly, reporting should allow clients to quickly and simply identify the full range of costs borne by their investments; enabling easy assessment of the net return to them; disclosure should necessitate transparent and consistent disclosure of portfolio turnover and costs such as commission spend.

Article 3I - Transparency of proxy advisors draft

- It is rightly important that the sector, as with all other intermediaries, is transparent in how it undertakes its activities and how it manages potential conflicts of interest.
- The use of proxy advisors can positively facilitate investors in carrying out their stewardship responsibilities to vote in an informed manner across often highly diversified portfolios.
- Importantly, the responsibility for the ultimate voting decision for each resolution at a company meeting lies with the investor, as such institutional investors themselves should disclose how and when proxy agencies inform their voting decisions.
- Care should however, be taken to not overplay the influence of intermediaries and it is imperative that the proxy agencies primary obligation remains to their investor clients.

Article 9 and 9b - Executive remuneration – right to vote on the remuneration policy and information to be provided in the remuneration report

- The NAPF believes that executive remuneration should be proportionate and aligned with shareholder interests and long-term sustainable value creation. Well-structured remuneration should be a contributor to the desired culture, values and ethos of a company.
- The right for shareholders to vote on a company's holistic remuneration policy every three years alongside an annual say on its implementation has been a positive and welcome introduction in the UK. Such rights are proving beneficial in shifting attention to the design of remuneration packages and the appropriateness of such arrangements in building and reinforcing long-term business success.
- Bringing greater transparency to pay schemes with more consistency in disclosures across EU member states is crucial in enabling shareholders to better understand the appropriateness of arrangements; however, it is important that care is taken ensure that disclosures are succinct and meaningful.
- It is important that remuneration committees should be able credibly to justify pay differentials within the company; however, we would suggest that the requirement for the disclosure of the ratio of the average remuneration of directors and employees is more of an implementation rather than a policy issue and as such should be a feature within the implementation report. It would also be helpful if there was more transparency on the relative importance of the spend on remuneration as against profit and dividends.

Article 9C - Related party transactions

- Shareholder rights to information about and approval of significant transactions including related party transactions vary greatly across the European Union. The NAPF is therefore very supportive of efforts to introduce consistent shareholder rights in respect of this important area of corporate governance.

- Pension funds are increasingly global investors. Figures from the NAPF's 2013 annual survey indicate that nearly a third of UK pension fund's investments are in listed equities; of this 42% is within the EU - of which 30% is invested in listed equities outside of the UK.

- Enhanced protection for minority shareholders across the single market should improve the attractiveness of European capital markets to global investors. The reduced cost of capital for European companies will be positive for broad-based economic growth.

- The inherent conflicts which arise between related parties can result in actions which significantly erode value for shareholders to the benefit of the individuals involved. Across Europe there are a variety of corporate structures and inconstant shareholder rights, by providing investors with greater confidence that their assets will not be expropriated by those in positions of dominance, investor confidence will be boosted and investment increased.

- The NAPF's own Corporate Governance Policy & Voting Guidelines stipulates that:

    - Company boards should have a robust, independent process for reviewing, approving and monitoring related party transactions (both individual transactions and in aggregate).

    - A committee of independent directors, with the ability to take independent advice, should review significant related party transactions and aggregate levels of related party transactions to determine whether they are necessary, appropriate and in the best interests of the company and, if so, agree what terms are fair for other shareholders.

    - The Board should confirm that all related party transactions have been reviewed and approved by the board, or if not how such transactions are monitored.

- Experience in the UK has demonstrated that the right to vote on certain related party transactions before such transactions are concluded does not result in undue burden but instead enhances investor confidence in management. However, in order to minimise any compliance burden exemptions should be introduced for transactions in the ordinary course of business.

Chapter 1a (articles 3a – 3d) - Identification of shareholders and facilitation of rights

Identification of shareholders (draft article 3a)

- The introduction of a consistent approach to the identification of shareholders across the EU is positive. However, the ability to identify shareholders should be a right for companies, rather than a possibility offered by intermediaries, we encourage the wording to reflect this. Great caution should be taken to ensure that the proposals do not result in engendering a system that is to the commercial advantage of the intermediaries in the chain at the expense of the investor and the investee company.

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- Efforts to empower shareholders and ensure they are able to exercise the rights attached to their shares is welcome. We would also wish to see the Directive entitle shareholders to use the details of the identified "shareholders" in order to exchange information and thus facilitate more effective collaboration in connection with subjects to be discussed at the AGM.

Facilitation of the exercise of shareholder rights (draft article 3c)

- The previous Shareholder Rights Directive sought to resolve the ability to vote shares effectively across borders and this objective should remain a core focus. Implementation across Members States thus far has been critical in increasing shareholder participation; however, some obstructions to cross-border voting do remain in some markets and as such this should remain a core focus of attention.

- We also believe that the proposed revisions should explicitly stipulate that the facilitation of the exercise of control rights is a "custodyship service" as set out in Appendix II of MiFID (ancillary services). Such a provision would guarantee that supervision of the obligation to cooperate is carried out under public law by national regulatory authorities.

- Additionally, it continues to remain difficult for institutional investors to obtain confirmation, whether from issuers or custodians that their voting instructions have been received and cast correctly. This is a further area which would benefit from the attention of the European Commission.

- Finally and more broadly, it is important that in order to encourage long-term active ownership both companies and investors are able to identify the 'beneficial owner' of a particular asset. Our members encourage the Commission to give this issue further consideration in parallel to this Directive.

Transparency on costs (draft article 3d)

- It is important and in the interests of both relevant parties – listed companies and investors – that any associated costs are kept to a minimum. In particular, neither the listed companies nor their shareholders would be well served by the charging, let alone of potentially excessive commercial prices, for the provision of services under the identification regulations. In view of the dependency of the intermediary chain, it would be more appropriate if the Directive restricted itself to establishing transparency and included effective provisions to prevent intermediaries from requiring disproportionate payment.

- Where charging does occur, it would be particularly regrettable (and contrary to the fundamental principal of free movement of capital) if intermediaries were able to make a distinction between domestic and cross-border services when levying charges.

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