The Chartered Institute of
Public Finance & Accountancy

Institutional Investors and Corporate Governance

Gerard Moore

CIPFA Associate

Institutional Investors and Corporate Governance

What we shall cover:

- A definition of corporate governance for a local authority pension fund
- Investment objectives and implementation within LGPS: relevant legal powers
- Issues and concerns with companies in which we've invested: risk controls
- Engagement & Action by shareholders (asset managers & underlying owners)

  - enhancing long term shareholder value
  - multi dimensional: responsible investment / responsible investor
  - setting a voting policy and seeking advice: proxy voting
  - implementation, monitoring and reporting
  - expectations, requirements, accountability & standards

- Expectations of stakeholders
- Stock lending and voting issues

A Definition

Corporate Governance for the LGPS
(similar to the local authority!)

- How the Administering Authority ensures it does the right things in the right way for the right people in a timely, inclusive, open, honest and accountable manner

- It comprises the systems, processes, culture and values by which the Pension Fund is directed and controlled, and through which it accounts to and engages with and where appropriate leads its communities

LGPS Investment Powers and Purposes

Wider fiduciary responsibilities: Counsel's advice to LGPS Shadow Scheme Advisory Board:

- fiduciary responsibilities to both scheme employers and scheme members
- Powers of investment for investment (not any wider) purposes
- Aim to achieve wide variety of suitable investments while balancing risks and rewards
- Precise choice of investments may be influenced by wider social ethical or environmental considerations
- But must not risk material financial detriment to the Fund

Also: Law Commission Report / Govt response /Prudential approach

Responsible Investment and Responsible Investor

INVESTMENT (decisions about whether to invest in a particular company /body /sector)

- wider stakeholders' interest: lobbying? Individual members?
- FRC UK Corporate Governance Code: best boardroom practice
- SRI (Socially Responsible Investment) is only a part
- Counsel's opinion: Social housing must be justified as an investment in its own right: also local property development
- ESG: Environmental, Social and Governance: the green agenda plus… tobacco, arms trade etc: you can avoid investing and select other investments producing a similar return relative to risk. Some Funds have specific exclusion policies.

INVESTOR (role once invested)

- Shareholder Engagement: long termism, not short-term unsustainable profits
- using your votes /Stewardship /maximise long term shareholder value

What's What? Who's Who?

- Corporate Governance Chain:
  investee companies/asset manager/end investors

- ESG: Environmental, Social & Governance
- SRI: Socially Responsible Investment
- Board Diversity: Equality & Human Rights Commission 2014
- UNPRI/ PRI: United Nations Principles for Responsible Investment
- FRC: Financial Reporting Council > Stewardship Code
- Prudential Regulatory Authority (PRA) & Financial Conduct Authority (FCA)
- LAPFF: Local Authority Pension Fund Forum
- ICGN: International Corporate Governance Network
- Kay Review: BIS/ short – termism in UK equity markets etc?

Looking at the long term value of a business in which a pension fund has invested

CIPFA The Chartered Institute of Public Finance & Accountancy

Corporate Governance: Investee Companies

Examples: BP Sports Direct M&S others?

Issues: H & S? Minimum Wage? CEO/Chair? Exec Pay?

Questions to ask/understanding the risks:
Roles played by the:
- non-executive directors?
- internal auditors and compliance
- external auditors
- investment banking advisers
- shareholders? Reputational risk

UK Corporate Governance Code (FRC) sets standards of good practice in relation to board leadership and effectiveness, remuneration, accountability & relations with shareholders

Impact of Public Accounts Committee?

The Chartered Institute of Public Finance & Accountancy

Corporate Governance
Institutional Investors

Financial Reporting Council (FRC)

The FRC sets and promotes high standards in accounting, auditing and actuarial practice. The FRC promotes high quality corporate governance and reporting to foster investment**.** But not a regulator for LGPS**.**

UK Stewardship Code 2010: updated 2012.

This Code sets standards for investors for monitoring and engaging with the companies they own and aims to improve the quality of dialogue between investors and companies to help improve long-term risk-adjusted returns to shareholders

Aims:

- Enhance the quality of engagement between institutional investors and companies
- Help improve long term returns to shareholders
- Efficient exercise of governance responsibilities

Basis "Comply or Explain" but not obligatory for underlying investors

https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Stewardship-Code-September-2012.pdf

Corporate Governance
Institutional Investors

Stewardship Code: FRC

Institutional Investors should:

1. Publicly disclose their policy on how they will discharge their stewardship responsibilities

2. Have a robust policy for managing conflicts of interest in relation to stewardship which should be publicly disclosed

3. Monitor their investee companies

4. Establish clear guidelines on when and how they will escalate their activities

5. Be willing to act collectively with other investors where appropriate

6. Have a clear policy on voting and disclosure of voting activity

7. Report periodically on their stewardship & voting activities

Corporate Governance
Institutional Investors

Shareholder Voting Policy

- Set an overall policy, make it transparent and adhere to that policy
- Report on outcome: Myners Principle 5:- voting records? evidence?
- Voting in other jurisdictions: enough knowledge & guidance?
- "Segregated holdings": direct voting
- Holdings within "pooled funds"
  - more complex: follow the approach of fund manager?
  - or ask whether "your underlying holding" can be separately voted
  - LAPFF paper March 2013
  - collective investment vehicles? Pools?
- Use of Proxy Voting agent: convenient, time saving
- Custodian needs to know from whom voting instructions will come

Local Authority Pension Fund Forum

- LAPFF exists to promote the investment interests of local authority pension funds, and to maximise their influence as shareholders whilst promoting social responsibility and corporate governance at the companies in which they invest
- Formed in 1990, the Forum brings together a diverse range of local authority pension funds (71) with combined assets of over £165 billion
- Covers climate change & employee engagement as well as more traditional concerns such as corporate governance & executive remuneration
- “Delegating Shareholder Engagement: Holding Fund Managers to Account”
- Has become a high - profile interventionalist organisation

Stock Lending 1

- Enables long term holders to benefit from short term demand for their securities, whilst retaining an economic interest (entitlement to dividends & other corporate actions)

- Involves a temporary loss of title, in exchange for an irrevocable undertaking to return equivalent securities, plus either:

  1. a fee plus non-cash collateral (government bonds, equities) or

  2. cash collateral, to re-invest, make a turn, & return to borrower or

  3. a guaranteed fixed income flow for the year

NB lender can recall when required, borrower can return when appropriate : vast majority are "on call"
but also "term loans" : pre-agree not to recall over a specific event e.g. over a scrip dividend option period or balance sheet

Stock Lending 2

Allowed within LGPS Investment & Management of Funds Regulations 2009: limits apply

But anticipated new regulations allow under Prudential arrangements

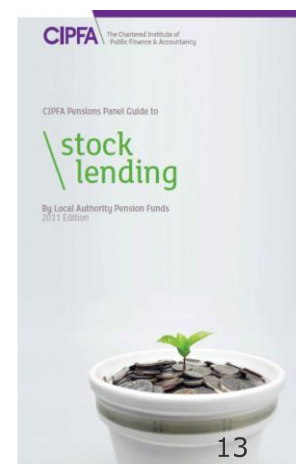
SIP to show lending policy and associated risks & mitigation

A discretionary activity: for segregated holdings, Fund can decide:
- whether to lend, what to lend, when to lend, when to recall.

Educational documents available, plus CIPFA Training Events (Myners Principle 1: effective decision making)

Stock Lending (aka Securities Lending) is an investment function: needs in-house expertise:

Don’t be over-reliant on agent lender



Stock Lending 3

Process

- Beneficial owners *(Pension Fund, Insurance Companies, Investment Funds, Sovereign Wealth Funds)* lend their stock, usually via a lending agent *(custodian, third party lender)* and receive a fee plus other stock as collateral, or just cash as collateral

- the borrowing side is represented by banks *(for balance sheet capital requirements)*, broker dealers *(for ongoing borrowing by hedge funds etc)* or market makers *(to cover shortage of stock).*

- When the stock is returned to the beneficial owner (one Principal) by the end borrower (the other Principal), the beneficial owner returns the collateral

CIPFA The Chartered Institute of Public Finance & Accountancy

Stock Lending 4

Fund’s Governance Policy: Lenders should set out their voting policy for stock out on loan

- Consider “costs of voting” i.e. borrowing fee lost when stock is recalled, relative to “benefits of voting” OR decide to recall all stock

- Arrive at your policy, tell your custodian and apply your policy consistently

  e.g.
  - recall all stock for voting, or
  - recall all UK stock for voting, or
  - recall only, e.g. when voting against management

- Be mindful of recall deadlines in other jurisdictions

- NB Don’t overlook the lending policy of the asset managers of your pooled funds!