

Institutional Shareholders' Committee

REVIEW OF THE INSTITUTIONAL SHAREHOLDERS' COMMITTEE STATEMENT OF PRINCIPLES ON THE RESPONSIBILITIES OF INSTITUTIONAL SHAREHOLDERS AND AGENTS – SEPTEMBER 2005

1. Introduction

- 1.1 The Institutional Shareholders' Committee published its Statement of Principles on the Responsibilities of Institutional Shareholders and Agents (the Statement) in October 2002. The Statement was aimed at furthering the application of best practice to the relationship between institutional investors and the companies in which they invest, with the object of securing value for beneficiaries over the longer term.
- 1.2 ISC member associations believe that the approach they adopted was preferable to legislation, which the government was considering at that time. However, they were aware from the outset of the need to maintain momentum so that best practice continues to evolve over time.
- 1.3 The ISC, therefore, committed to monitor progress through a formal review of the Statement two years after it was launched. This paper constitutes the conclusions of that review.

2. Summary and outline conclusions

- 2.1 Evidence of the Statement's impact on behaviour comes from direct feedback to the ISC from institutional investors and companies, from concrete steps taken by ISC member associations, and from surveys conducted by both the IMA and NAPF. All of these sources point to a significant change in the approach of institutional shareholders and agents (institutional investors) in the nearly three years since the Statement was published. In summary, there has been a general increase in the level of engagement with investee companies.
- 2.2 The ISC has, therefore, concluded that there is no need to rewrite the Statement of Principles, although the current version, attached as Appendix 1, has been modified in two respects.
 - The word activism has been replaced with engagement. This is to emphasise the importance now attached by institutional investors to developing a high quality all-round relationship with the companies in which they invest.

- The recommendation in the existing Statement that institutional investors should state their policy for requiring investee companies' compliance with the core standards in the Combined Code has been removed. It is a listing requirement that companies have to confirm whether they comply with the Code or explain where they do not. The ISC expects that institutional investors will apply the Code and consider companies' "comply and explain" statements when deciding how to vote their shares. In addition, some institutional investors will legitimately continue to set standards in addition to those in the Code.
- 2.3 The ISC review has, however, pointed to a number of ways in which the engagement process could be improved.
 - 2.4 The original letter from the ISC to the Minister suggested that pension funds would be encouraged to revise the contract terms adopted when investment managers are appointed. In practice, it has become clear that definitive wording in funds' Statement of Investment Principles (SIPs) is also effective, transparent to investors and practicable to implement. Accordingly, the ISC now recommends that pension funds should incorporate the principles into their SIPs. Furthermore, IMA's standard terms for discretionary fund management now include suitable wording and pension funds are encouraged to adopt these terms in addition to the position adopted in their SIP as soon as practicable.
 - 2.5 A survey by the NAPF – see below - shows that approximately two thirds of 66 pension funds surveyed have adopted the Statement, either by amending their contracts with fund managers or by making reference to the Statement in their Statement of Investment Principles, or in a side letter. This gives a clear direction to fund managers as to their obligations.
 - 2.6 There have been concerns that the corporate governance aspect of engagement is not integrated with the investment process. While considerable progress has been made in addressing this, there is a general recognition that more could be done. There is also scope for improving the interface between pension funds, as the beneficial owners, and their agents, the fund managers. Effort in this area should lead to more informed discussions, a greater emphasis on the quality of the fund managers' relationship with investee companies and more consideration of the effectiveness of actions taken. That said, the extent to which governance can be integrated with the investment process will vary from fund manager to fund manager.
 - 2.7 Separately, it would be helpful if there was greater consideration by investment consultants of fund managers' approach to engagement when they are advising on selection, taking into account the relative

importance of other factors. Trustees similarly should give careful consideration to this amongst other factors, when evaluating their actual or prospective fund manager(s).

- 2.8 The above points have been carefully considered as part of this review and are reflected in the action points below. The following sections of this paper describe actions taken, analyse the surveys undertaken by the IMA and NAPF and set out action points aimed at building on the progress achieved to date.

3. Progress achieved to date

- 3.1 Collectively, the member associations of the ISC have taken a number of steps to facilitate and enhance the engagement process.
- 3.2 The ISC pushed successfully for the reactivation of the Shareholder Voting Working Group, which has led to widespread development of electronic voting and increased the reliability of the voting process. The NAPF has recently published guidance for trustees on voting entitled "Voting Made Simple".
- 3.3 The NAPF has revived its Case Committee procedures, while the ABI has maintained its previous practice of facilitating collective engagement by its members with companies. The caseload is currently running at about fifteen to twenty cases a year (excluding consultations with companies on remuneration policy changes which for the ABI amounted to 209 cases in 2004 compared with 166 in 2003).
- 3.4 The NAPF is carrying out a major review of the governance of pension schemes and the role of trustees which will be published in 2005. This is looking at the requirements for effective governance and engagement, and will assess current and alternative practices and recommend areas for improvement and change. The NAPF has also launched a new on-line Trustee Development Programme to train trustees and equip them with the required knowledge and understanding.
- 3.5 The ABI and NAPF jointly published a statement concerning contracts and severance, which was designed to limit severance payments to executives who were deemed to have underperformed. The paper has helped reduce the incidence of "reward for failure" and led to an almost total elimination of service contracts in excess of one year. Many of its principles have subsequently been adopted by the CBI.
- 3.6 The ABI and NAPF each provide a voting issues service and both have taken significant steps to improve them.

- 3.7 The IMA Board has published guidance on the way its members should approach engagement. The ABI Board has approved a statement on considered voting calling on its members to exercise their votes and inform companies when they choose to oppose or abstain.
- 3.8 The AITC has published a corporate governance Code for investment trust companies, which highlights the need for investment trust directors to take account of the ISC Statement of Principles and the need to consider contract revisions when management agreements fall due for review. The Code has been widely adopted within the investment trust sector.
- 3.9 The NAPF and IMA have carried out surveys of their membership on their approach to engagement. The IMA survey also covers most leading members of the ABI in their function as institutional investors. It is the intention of both organisations to repeat these surveys annually to assist the ISC in monitoring the evolution of engagement.
- 3.10 The results of these surveys are analysed below. They form the basis of a number of the action points set out in the final section.

4. Results of IMA and NAPF surveys

- 4.1 The IMA's survey covered 34 fund managers and is the IMA's second survey of engagement in that a similar exercise was undertaken in 2003. As at 30 June 2004, these 34 managers represented 55 per cent (£552 billion) of all UK equities managed within the UK. The NAPF's survey is the first survey of its kind by the NAPF and covered 66 pension funds, including all 50 of the biggest funds, with assets of approximately £350 billion, which is approximately half the total assets of all UK pension funds.

The principal findings are set out below.

Increasing interest in and levels of engagement

- 4.2 The summary and outline conclusions above state that there has been a general increase in the level of engagement with investee companies. In the main, pension funds will delegate engagement to their fund managers. Both surveys evidenced that, although engagement policies are not a key criterion in pension funds' selection of a fund manager, there is growing interest and several funds acknowledged that it is likely to become increasingly important in the future.
- 4.3 In this respect, the IMA's survey shows that managers' engagement has increased in the quarter ended 30 June 2004 from the same quarter last year, both in terms of the number of meetings with

independent directors to discuss concerns and communications with management over and above routine meetings. Indeed, in the three months to 30 June 2004, managers reported over 1,000 communications with management, nearly two and a half times the level in the same quarter in the previous year. In addition, managers now have an express policy to vote more categories of shares than in 2003. Currently, all 34 managers, with two exceptions, have a policy to vote all their UK shares and the majority vote all or some of their international shares.

Increased resources dedicated to engagement

- 4.4 As noted, pension funds tend to delegate engagement to their fund managers and thus will not necessarily have their own resources. (That said, over a third of pension funds allocated additional resources to engagement over the last two years.) In this respect, 80 per cent of the pension funds believed that more resources were being committed to engagement. This was supported by the IMA's survey in that all the managers, with one exception, employ staff who are dedicated to engagement on corporate governance or socially responsible issues and since 2003, numbers had increased by about 10 per cent.

Incorporating the Statement of Principles into Contracts and Policy Statements

- 4.5 Most investment management contracts include provisions governing policies on voting. The majority of funds – 60% - had taken the Principles on board in one or more of three forms as follows. 17% had incorporated them directly into their investment managers' contracts. 15% had instructed managers to use the ISC Principles for guidance by means of a side letter. The most common way for funds to incorporate the ISC Principles was by inclusion in the scheme's Statement of Investment Principles (SIP). 42% had included them in this way. A number of the 26 funds which said they had not incorporated the ISC Principles in one of the three ways outlined above had used other ways to achieve compliance.
- 4.6 33 of the managers have a clear policy statement on engagement (one manager's statement is still in draft). 21 of these publish their policy in whole or in part on their web sites, while a further five make it available on request; this compares with 14 and four respectively out of 28 in 2003. A number of managers highlighted that they always give clients a copy of their policy on appointment and that this reflects the Statement.

"Joined-up engagement"

- 4.7 It is noted above that some feel that more could be done to ensure that the corporate governance aspect of engagement is "joined-up" with the

investment process. In this respect, the IMA Board's guidance on engagement goes some way to explain why it may not appear to be integrated.

"Most company meetings with fund managers will be on issues about company strategy/performance and not longer-term stewardship and therefore are attended in the main by portfolio managers and research analysts. Fund managers often, however, employ governance experts, with voting and other agencies to assist, and in some cases these individuals may have different lines of communication with companies, for example, via the Company Secretary rather than the head of investor relations."

- 4.8 The IMA's survey identified that, although fund managers may have different lines of communication with companies, decisions on policy or on crucial votes are taken by those involved in the investment process in that they are taken by senior management and/or those that manage the investments. For example, in 16 of the 34 managers' final decisions on contentious issues are taken at a senior level in the organisation and by or with the active involvement of fund managers in a further 17; in only one is the decision reserved to the corporate governance specialist.

Fund managers reporting to clients

- 4.9 All 66 pension funds receive regular reports on voting and engagement from their fund managers. In this respect, 32 of the 34 managers report quarterly to their clients, mainly covering details of how they have voted, notably resolutions voted against the board or consciously abstained, together with the reasons. Seven managers publish their voting records on their web sites, compared with two in 2003. In this respect, a number of pension funds were dissatisfied with the quality and comprehensiveness of reporting from some managers.

5. Action points

- 5.1 Based on the foregoing analysis the member associations of the ISC have agreed the following action points:
- The IMA and NAPF will continue their annual surveys to monitor progress and identify where more should be done. The ABI will have regard to the results of the IMA survey, which covers its main investing members. Where relevant, future surveys will also cover specific progress with regard to other action points set out in this section. Such points are marked with an (S) in the text. The survey results will be published.

- All members of the ISC will work to raise the quality of fund managers' feedback to their clients so that the latter can achieve a better understanding of the role of engagement in the investment process and the performance of their fund managers in this area. The ISC suggests that fund managers should review their feedback arrangements and improve them where appropriate (S). The NAPF will prepare guidance for its trustee members on understanding and using feedback effectively (S). The ABI Investment Committee will prepare a policy statement for the insurance industry.
- The ISC recommends that pension funds make reference to the Statement in the trustee's Statement of Investment Principles (SIPs). Section 26 of the Pensions Act 1995 requires fund managers to act in accordance with the SIP. Perhaps more important than the legal sanction, however, is a mutual understanding between trustees and fund managers of the importance of the issue and the way in which progress is reported and monitored by trustees.
Furthermore, IMA's standard terms for discretionary fund management now include suitable wording, and the ISC encourages this to be adopted by funds as soon as practicable, provided this does not result in unnecessary costs to pension funds. Where existing arrangements need to be amended, it is anticipated that this will either be through side letters or amendments to agreements. The annual surveys will cover both progress and the techniques used with a view to refining best practice as appropriate (S).
- The ISC suggests that pension fund trustees consider whether they should instruct consultants to include a fund manager's track record on engagement as a criterion in the selection process, bearing in mind the balance of costs and benefits.
- The ISC will convene a working group of practitioners to compare experiences and draw conclusions about the usefulness of particular approaches and the effectiveness of engagement. The group will report back to the relevant Council/Committee of member associations.
- The ISC recommends that the chief executives of fund managers review regularly the level of resource given to engagement, its quality, and whether it is deployed in such a way as to ensure that engagement is properly joined up to the investment process (S).
- ISC members will use the forthcoming review of the Combined Code to help promote more effective engagement with an emphasis on developing the all round quality of the relationship between companies and shareholders. To help with this process, the ISC

recommends that fund managers designate a central point of contact for companies wishing to raise matters with them (S).

- The ISC will formally review the impact of the Statement again after a further two years.

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