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Draft submission to Which? Consumer Policy Review from Dr Robin Keyte APFS of  
Towers of Taunton (Financial Services) Ltd on the matter of Shareholder Engagement  
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## Introduction

This submission relates to the UK share market and in broad terms, identifies who owns the shares in UK companies and how that may, or may not, affect the way those companies are run.

We believe that investors, especially in their role as shareholders, have moral responsibilities with regard to the companies in which they invest.

It is widely accepted that individuals are responsible, not only for their own actions, but also, under certain circumstances, for the actions of those who act on their behalf. We believe this principle extends to the corporate context. As a general principle shareholders approve the composition of the board. The directors have a fiduciary duty to conduct the business on the shareholders' behalf and in their interests. Thus it is reasonable to accept that shareholders have a wider responsibility, under certain circumstances, for the actions of companies.

While company law strictly limits the legal liability of shareholders, it does not thereby limit their moral obligation. This is not to say that shareholders' responsibility in this regard is open-ended. Effective control of companies, in law and in practice, lies with the directors. This is therefore where the main burden of responsibility for the company's actions should rest. However, given that shareholders approve board composition, the primary role of shareholders is to support, encourage and, where appropriate, challenge the directors in their efforts to achieve high standards of governance and corporate responsibility.

In our view, the majority of the UK share market is held by 3<sup>rd</sup> party fund managers on behalf of the consumers who invest into their funds. Furthermore, that those 3<sup>rd</sup> party fund managers give little or no consideration to the concerns of those same consumers with regard to social, ethical or environmental (SEE) issues.

However, there is an established practice for raising SEE concerns with investee companies, which is known as 'engagement'. In a toolkit on Responsible Investment published by UKSIF ([www.uksif.org](http://www.uksif.org)) in 2005, the practice of 'engagement' is defined as follows:

'Engagement, also known as shareholder activism, is applied by some fund managers to encourage more responsible business practices. It relies on the influence of investors and the rights of ownership. This might not alter stock selection and mainly takes the form of dialogue between major investors and companies on issues of concern, and may extend to voting practices. Fund managers may engage on areas such as inappropriate remuneration and climate change.'

Our experience has taught us that those few consumers that know about engagement value it as a practice and prefer to invest in funds that have a published engagement policy.

A good example of engagement working in practice was the GlaxoSmithKline shareholder revolt in 2003 when over 50% of GSK shareholders voted against the proposed remuneration package for the company executives. In essence, engagement aims to bring about more responsible corporate conduct on SEE issues by getting companies to focus on the longer term, and at the same time protect shareholder value from potential reputational risk and the sort of price volatility often associated with short-termism.

Consumer bodies like Which? should be interested in this area as effective shareholder engagement would lead to a more even relationship of mutual benefit between the various stakeholders. This would be entirely relevant to the Time for a Change and related campaigns.

There is very good evidence that most consumers want SEE issues taken account of. Research conducted by UKSIF / NMG (November 2003) found that out of 674 UK investors:

- 9 out of 10 feel they have a duty to challenge BOTH excessive, undeserved directors pay and other unethical company practices
- 78% are concerned that their fund managers do have policies related to ethical and environmental issues
- 71% would NOT buy any investment products from company's that ignored ethical and environmental issues

In addition to this, a survey conducted by Friends Provident / NOP (August 2003) found that out of 998 people aged 15 or over, 76% said they did not want to invest in companies with poor SEE policies.

Whilst the view may be held that members of the public might generally profess an interest in ethical issues when surveyed because respondents feel in some sense encouraged to give what appears to be an appropriate answer at the time, we would conservatively estimate that between  $\frac{1}{3}$  and  $\frac{1}{2}$  of all consumers would be interested in shareholder engagement on SEE issues.

However, at the present time, the management of the vast majority of investments and pension funds takes no account of, and is completely divorced from SEE concerns.

So why do fund managers not carry out engagement as standard practice at present?

- i) We believe that there is a high degree of mutual ignorance at the present time. Most fund managers do not perceive that their investors want engagement. At the same time most consumers are not aware of the existence of engagement or that fund managers might practice it as a standard service.
- ii) Fund managers are not incentivised to carry out effective engagement at present.
- iii) There is a potential conflict of interest as fund managers are generally part of very large companies with multiple corporate commercial relationships, so bluntly the

fund management arm would not want to 'rock the boat' for other arms of the same organisation.

All of these issues need to be overcome as the current market is failing the needs of consumers. Most financial advisers have a poor awareness of socially responsible investment and hence do not ask their clients about it. As for company pension schemes, despite the requirements of The Occupational Pension Schemes (Investment) Regulations 1996, it is our view that the Statement of Investment Principles is being broadly ignored by most fund managers.

## **Assessment of the Current Position**

There are various categories of investor (some of which are consumers) that have direct holdings in UK shares which are broadly summarised below. We briefly look at each one in turn from the point of view of shareholder voting rights. (For the avoidance of doubt, this submission on shareholder engagement is concerned with much more than just shareholder voting rights, but in this instance just looking at voting rights is a useful exercise.)

### **1. Private Individuals**

Private individuals with direct investments in shares either hold the shares personally or through a nominee account arrangement with a stockbroker / fund manager.

An individual holding shares personally will receive all papers relating to issues being put to a shareholder vote, and can respond appropriately.

An individual holding shares through a nominee account will not receive any papers relating to issues being put to a shareholder vote, and must rely upon their stockbroker / fund manager to respond appropriately on their behalf.

Regrettably, the vast majority of stockbroker / fund managers do not ask their clients about any concerns they may have on SEE issues which might affect how they vote on behalf of their clients (for instance whether or not to support executive 'fat cat' pay deals). Nor do most firms of this type have a clear voting policy on SEE issues that might help individuals pick a firm that represents a good match to their own personal values.

### **2. Institutional Pension Funds**

Institutional pension funds are run by trustees who are supposed to act in the best interests of individual pension scheme members. In most cases the trustees will engage third party fund managers to manage the pension fund assets as portfolios of stocks and shares.

The trustees are required to publish a 'statement of investment principles' (SIP) which sets out the extent to which (if at all) SEE issues are taken into account when decisions are made about whether to buy or sell pension fund holdings.

The trustees should then instruct the third party fund managers to exercise their shareholder voting rights on holdings in the fund in line with the SIP.

The main problem that arises here relates to whether the SIP is in line with the SEE concerns of most scheme members. Given that the pension scheme assets are irrevocably for the benefit of scheme members, it is reasonable to expect trustees to take this into account, regrettably however most scheme trustees simply do not bother to ask or survey their members.

Also, the contract associated with the 3<sup>rd</sup> party fund management is often short, typically just 2 or 3 years. The fund managers therefore often look for short term investment outperformance in an attempt to retain the investment mandate at the end of the term, and just do not bother with fulfilling the requirements of the SIP. This can increase the risk and volatility associated with the portfolio which is rarely in the best interests of the underlying scheme members.

### 3. Retail Pension Funds

Retail pension funds are run by insurance companies and the investment function is carried out by the fund managers acting on behalf of the insurer. These may be the insurers own in-house fund management function or other asset management companies potentially available through fund links.

Regrettably, the vast majority of retail pension funds do not ask their policyholders about any concerns they may have on SEE issues. Nor do most retail pension funds have a clear voting policy on SEE issues that might help individuals pick a firm that represents a good match to their own personal values.

There are however a handful of exceptions where some asset management companies are leading the way on responsible use of shareholding voting rights.

### 4. Collective Investment Schemes

Collective investment schemes covers unit trusts, open-ended investment companies, investment trusts, investment bonds etc. The investment function for collective investment schemes is either carried out in-house or by fund managers acting on behalf of the asset manager or insurer.

Regrettably, the vast majority of collective investment schemes do not ask their investors about any concerns they may have on SEE issues. Nor do most collective investment schemes have a clear voting policy on SEE issues that might help individuals pick a firm that represents a good match to their own personal values.

As before, there are a handful of exceptions where some asset management companies are leading the way on responsible use of shareholding voting rights.

### 5. Trusts & Charitable Trusts

Trusts are run by trustees who are responsible for the investment of the trust assets. As a matter of good practice trusts are encouraged to have a SIP and this is particularly pertinent to charitable trusts with investment income exceeding £1 million pa.

In practice, most trusts invest their assets in collective investment vehicles or nominee accounts with stockbroker fund managers and aside from large charitable trusts, give little or no consideration to use of shareholding voting rights.

## 6. Corporate Bodies

Shares in companies can sometimes be held by other companies for strategic or commercial reasons. Any use of shareholder voting rights will principally be driven by commercial issues.

The current position for these 6 categories of shareholder can broadly be summarised as follows:

Category	Underlying Investor	Fund Manager?	Voting Rights?	Take account of SEE issues
Private individuals	Retail consumer	Directly held – No	Per private individual	Yes
		Nominee account – Yes	Per stockbroker	Very rarely
Institutional pension	Retail consumer *	Yes	Per fund manager	Rarely
Retail pensions	Retail consumer	Yes	Per fund manager	Very rarely
Collective investment schemes	Retail consumer	Yes	Per fund manager	Very rarely
Trusts & charitable trusts	Trust	Yes	Per fund manager	Rarely
Corporate bodies	Corporate body	No	Per corporate body	N / A

\* Pension scheme members can essentially be viewed as retail consumers

Of the above six categories of investor / shareholder, the first four relate directly to individual consumers who are either direct investors in shares, or members of pension schemes that invest in shares, or investors in collective investment schemes.

These 4 categories are thought to account for the ownership of more than 2/3<sup>rds</sup> of the FTSE All Share market.

Despite this, it is regrettable that little or no account is taken of the SEE concerns of the underlying investors / scheme members when fund managers are presented with opportunities to use the shareholder voting rights associated with the holdings they manage.

It is therefore clear that at present there is a total lack of alignment between the SEE concerns of underlying investors and the management of their pension / investment funds.

## **Challenges**

1. So how can we persuade fund managers to carry out engagement as standard practice?

The bubble of mutual ignorance needs to be pierced. Consumers need to be made aware of the existence of engagement and that fund managers should practice it as a standard service. Consumers should also be provided with a reviewable list of fund managers that practise engagement. Fund managers need to be made aware

that more consumers want engagement to be provided as a standard service. Consequently fund managers need to:

- have policies and processes that define their aims on SEE issues and the scope of activities.
  - have research and analysis that enables further understanding around the impact of SEE issues on companies.
  - carry out activities that include the use of shareholders' rights in interactions with investee companies, essentially via meetings, letters, participation in Annual General Meetings and voting.
  - recognise impacts of engagement can include shifts in company behaviour with respect to SEE issues and pivotal investment decisions (such as hold or sell).
2. At the same time there needs to be some form of independent assessment of the quality of the engagement being practiced, to stop fund managers from just 'greenwashing' their funds as a public relations / spin exercise.

The current audit of UK fund managers with retail socially responsible investment offerings against the euroSIF Transparency Guidelines ([www.eurosif.org](http://www.eurosif.org)), which is being carried out by the Ethical Investment Association ([www.ethicalinvestment.org.uk](http://www.ethicalinvestment.org.uk)) and funded by Polden Puckham Charitable Foundation, may hopefully provide just such an assessment. The audit is due to be carried out 3 years running with results to be reported publicly.

3. The ultimate goal is to design and develop a consumer facing demand orientated mechanism with the aim of driving more responsible engagement by UK fund managers generally, over a wider range of SEE issues including corporate governance / corporate social responsibility.

Indeed, such a mechanism would be all the more effective where the underlying investors / retail consumers were also customers of the investee companies (i.e. UK banks, financial services companies, supermarkets, utilities providers etc)

## **Conclusion**

I am reminded of an old rural expression in the West Country which is "the payer is the sayer". In this case, the payer is the consumer / underlying investor as without their money, pension schemes and investment funds simply would not exist. We need to make fund managers listen to what they are saying on SEE issues.

It is time to make investors aware that fund managers are not engaging with investee companies on SEE issues. It is time to start driving for this position to be changed, and to bring about a new era of connected share ownership, where the concerns and views of individual investors are taken into account and aligned with the engagement activities of the fund.

The starting point for all of this could be Which? members, or any other sizeable consumer group, and an article describing shareholder engagement and the current problem, and listing the handful of fund managers that practice it as standard at present.

Is it worth the effort?

The long-term consequence of a successful engagement campaign from the point of view of an investee company might be an effective focus on risk minimisation and/or returns improvement, taking into account the following factors:

- recent high-profile scandals have highlighted the need for appropriate corporate governance and risk management systems.
- a growing body of laws, such as site clean ups and carbon trading, create a new form of liability or risk for companies.
- both consumer awareness and reputational risk is increasing for companies that fail to meet some regulatory or consensual standards such as persistent misselling of financial products or use of slave labour, for example.
- environmental and social innovation are proving to be excellent drivers for business growth. This is partly linked to new demands by consumers.

The long-term consequences of a successful engagement campaign from a consumer point of view might be:

- more products or services designed with fairness in mind and hence a greater share for the consumer of the relationship of mutual benefit (i.e. lower cost, improved service, better value)
- products and services that are more environmentally friendly
- an increase in levels of trust between consumers and providers of products and services
- fund managers that are more answerable to their investors
- company executives that are more answerable to their shareholders / fund managers
- a consumer facing demand orientated mechanism with the aim of driving engagement by UK fund managers on the SEE issues of concern to consumers. This will evolve as awareness of consumers towards existing and new SEE issues changes over time.

That has to be worth campaigning for.