

Pension Funds and the ISC Code – A Practical Guide

Introduction

Pension funds are major institutional investors and take their responsibilities as owners of UK companies seriously. The NAPF has been at the forefront of raising standards of corporate governance for many years and our Policies are widely used by investors as a guide to best practice. Companies regularly consult with us on corporate governance matters.

Funds will be aware that one of the perceived weaknesses of the corporate governance regime is a failure by them in overseeing the activities of their agents to whom most delegate the responsibility for engagement and proxy voting. That is to ignore the considerable efforts of many funds to raise standards of corporate governance and to advance policy improvements. But, nonetheless, they, along with other market participants, should question whether their application of corporate governance policies could be more effective.

This note has been prepared to assist pension funds to understand their obligations under the ISC Code. We recognise that, as the structure of the Code is still under discussion, led by the Financial Reporting Council, there may be changes to it. There will certainly be developments in the way it is applied.

However, the NAPF believes that pension funds should begin now to consider how they should adapt to its requirements, as a stronger corporate governance culture will help to protect and enhance the value of their investments.

We plan to publish more detailed guidance on applying the Code in due course.

Background

The Institutional Shareholders' Committee (ISC) published its Code on 16th November 2009, following extensive consultation with institutional investors. It represents part of the industry's response to the weaknesses identified in the aftermath of the financial crisis. Its provisions cover asset owners, such as pension funds, and their agents, including advisers and investment managers.

The Code has received broad support from Sir David Walker (labelled the "Stewardship Code") and the Financial Reporting Council, both of whose governance reviews were published shortly afterwards. They have proposed that the Code be brought under the supervision of the FRC.

In its *Guidance on Responsible Investing*, published in March 2009, the NAPF recognised the importance of effective monitoring by funds of their agents and by the agents in turn of the companies in which they invest. It is the companies, and specifically their boards, which have ultimate responsibility for maintaining the highest standards of corporate governance and protecting the interests of their shareholders.

By setting clear and proportionate standards of application of the ISC Code, we aim to encourage funds to incorporate effective monitoring of engagement into their periodic manager reviews and thereby help to raise standards of corporate governance in the UK.

Application

The Code (which replaces the ISC Principles) will be applied on a "comply or explain" basis. Size alone is not seen as an impediment to effective application of the Code, as smaller funds usually delegate investment management to a third party, which should be competent to meet the requirements of the Code.

It is intended that funds which apply the Code will be listed on the ISC website, as will the investment management firms. We suggest that funds use the ISC list when reviewing managers or considering new appointments. Note that the ISC/FRC has yet to set out the procedures for listing.

At this point it is not envisaged that the ISC will monitor the approaches to applying the Code, but we anticipate that there will be general reviews of its application and that advisers may develop more detailed monitoring tools.

We set out below the Code's Principles, along with suggestions as to how funds should apply them. We have particularly focussed on those funds, whatever their size, which delegate investment management to a third party. The Principles apply equally to self-managed funds.

Principle 1: Institutional investors should publicly disclose their policy on how they will discharge their stewardship responsibilities.

Funds' policy statements could include a description of how responsible investing policies are incorporated into the overall investment policy, its place in the investment process and reporting procedures.

Funds should state where they have chosen not to apply the Code, and explain the reasons.

A detailed policy description should be provided by the investment managers to the fund and should be consistent with the mandate and the ISC Code, if applicable.

Question:

Do we have a clear policy which is incorporated into our investment management agreements and/or Statement of Investment Principles?

Principle 2: Institutional investors should have a robust policy on managing conflicts of interest in relation to stewardship and this policy should be publicly disclosed.

Pension fund trustees already have a policy on conflicts of interest, which should also extend to cover investment matters. They should have an explicit policy for dealing with conflicts with the sponsor(s) which may arise over corporate governance or voting. Likewise their investment managers should clearly state in their investment management agreement how they propose to address conflicts. Both should agree at the start which issues, if any, are reserved for the decision of the trustees.

Question:

How do we address conflicts of interest which may arise from stewardship issues?

Principle 3: Institutional investors should monitor their investee companies

For those funds which delegate investment management to third parties, a monitoring report should form an integral part of the regular reporting material which they receive from their advisers or agents. Funds should not be expected to duplicate the work of their investment managers, but it is the trustees' responsibility to ensure that sufficient time is given to overseeing their managers' compliance with the agreed policies.

Question:

How do our managers monitor the companies in which they invest our money?

Principle 4: Institutional investors should establish clear guidelines on when and how they will escalate their activities as a method of protecting and enhancing shareholder value.

This follows on from the previous Principle and, like it, is a matter for agreement between contracting parties from the start. Funds will want to know when concerns have been escalated in the way envisaged in the Code and to understand how their interests have been protected as a result. Some funds may choose to prohibit escalation without prior consultation.

Question:

Can our managers cite examples of escalation of their concerns, and what happened?

Principle 5: Institutional investors should be willing to act collectively with other investors where appropriate.

Funds should encourage collaboration between investment managers as a means of more effective engagement. They should be clear about their managers' approach and should expect a report on such collaboration. The NAPF also supports more direct involvement by funds in such efforts where the presence of the end-owner of

the stock may add weight to the arguments and ensure that their views are properly conveyed to the company concerned.

Self-managed funds may find it helpful to make use of the NAPF's Case Committee facility where they wish to act collectively with other funds.

Question:

Are our fund managers committed to collaborating with others, when appropriate?

Principle 6: Institutional investors should have a clear policy on voting and disclosure of voting activity.

Funds will be expected to state their voting policy and summarise their voting activity to members in future. While there remains real concern about the risk of boiler-plate (as has happened in the US) it is clear that there is growing support for improved disclosure – indeed many funds and their managers already provide a good standard of public disclosure.

Question:

Does the fund have a voting policy, whose application is clear from the reports produced?

Principle 7: Institutional investors should report periodically on their stewardship and voting activities.

This Principle operates at different levels for funds and their investment managers.

For funds, we recognise that there are significant practical problems around disclosure, but encourage them to generate a report for their members which sets out the key voting issues during the year and how the fund has addressed them. Each year there are several meetings which are especially important and worthy of comment. Of particular interest are votes on shareholder resolutions, which are uncommon in the UK but tend to be of more interest to members. Such an approach will also demonstrate that there is effective monitoring of the investment managers.

Given the size of most portfolios it is not practical to expect the manager to report on each stock held, but we recommend that reporting to trustees goes beyond exception reporting (covering breaches of policy, votes against management etc). Investment managers should be expected to demonstrate not only that procedures are in place covering engagement and voting as set out above, but also how effective the engagement activity has been in protecting their client's interests. For example they may choose to discuss key holdings which have performed poorly over a period of time.

In this context we see the development of more effective reporting and possibly an extension of the AAF01/06 report as having an important role to play in demonstrating that funds' agents are applying their stated policies.

Question:

How effective is communication with investment managers, and thereafter to members, on stewardship and voting?