ENCOURAGING SHAREHOLDER ACTIVISM

A CONSULTATION DOCUMENT

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INTRODUCTION

1. The Myners' Review of Institutional Investment in the UK was commissioned by the Chancellor of the Exchequer in the 2000 Budget, to investigate whether there were factors distorting institutional investment in the UK, resulting in inefficiency and inflexibility in capital markets. It reported at the time of the 2001 Budget.

2. The review found that, although to a degree, institutional investors (largely pension funds and insurance companies) are engaging with companies in which they invest, there is currently a lack of active intervention in such companies even where there is a reasonable expectation that this would enhance the value of investments. Specifically it found that fund managers argued that there was no need for them to engage in such intervention, either because it was not part of their role or because there was no need for them to adopt such a strategy. The review concluded that this situation is a matter for concern and suggested legislative reform.

3. **The review recommended that UK law should incorporate a duty (similar to one imposed under US legislation), on those responsible for the investment of pension scheme assets. The duty is, broadly, to actively monitor and communicate with the management of investee companies and to exercise shareholder votes where, after taking into account the costs of any action, there is a reasonable expectation that such activities are likely to enhance the value of an investment.** The relevant US legislation is set out in the Employment Retirement Income Security Act 1974 (ERISA), and is supplemented by guidance issued by the Department of Labor. The recent report of the joint CBI-TUC working group on best practice and productivity expressed the CBI's and TUC's support for this principle and stated that the Myners review had been right to make this recommendation. **Background information is in the attached annex.**

4. The Government has taken forward the recommendation of the Myners' review. This consultation paper sets out and seeks views on the broad nature of legislation proposed to implement the recommendation. It is one of three papers being issued, the others relating to trustees and to the role of an independent custodian.

5. In addition, the Company Law Review made separate proposals on institutional voting which are relevant to this area. It suggested that future legislation on company law should contain a power enabling the

Secretary of State by statutory instrument, subject to the affirmative procedure, to require such public disclosure of this information by some or all institutional investors, but that this power should only be invoked "if it proves necessary in the light of experience." This consultation paper does not seek to take that proposal forward, but it is an important part of the context for the policy developments proposed. The Government will publish its conclusions on company law in due course.

PROPOSED REFORM

The public policy concern

6. There has been considerable activity in the field of corporate governance in recent years, focused on the provisions of the Combined Code.

7. The Myners review was concerned, however, with a specific issue: action by shareholders to tackle corporate underperformance.

8. It is clearly not the responsibility of the shareholders of public companies to manage companies on a day to day basis. But broad issues such as the performance of senior management and the appropriateness of their strategy for the company are legitimately the concern of shareholders. In order to prevent or tackle major flaws in such areas, shareholders have both the right to become involved and an economic interest in doing so. Ultimately, where they feel that the existing management are not addressing these issues to their satisfaction, it is appropriate for them to take action.

9. This action may consist of simply selling the shares and so ending their involvement with the company. But in practice, for large institutional investors, this is not always possible. The price impact of such a major sale of shares may be prohibitive, and where the investee company is a major one with a significant weighting in the relevant market index, a zero holding of their shares may also not be possible. In reality, even where major investors have significant concerns about large public companies, they typically retain some shareholding in them.

10. There is clearly a general public policy interest here. The efficiency and effectiveness of company management and strategies have profound and major impact on economic performance. It is an important and legitimate issue for Government to ensure that the legal and regulatory framework supports shareholders in scrutinising these issues.

11. There is an additional specific public policy interest in the case of pension funds. The ultimate beneficiary is typically two steps removed from the investment decisions. The pension fund is the end investor rather than the beneficiary, and the investment decisions are typically being taken by external fund managers. It is important therefore to ensure that decisions taken at these two intermediate stages meet beneficiaries' best interests.

12. For most investments most of the time, it is likely that the best interests of beneficiaries do not require either the institution concerned or its fund managers to intervene actively in the company concerned to tackle underperformance. But where a holding in a major company is concerned, it may not be practical for a fund manager to sell all its holding, or to hold no shares at all in the particular company.

13. However, the Myners review found that, while there were instances where institutional investors were intervening in investee companies, there was also a broader culture of non-intervention. Recent academic research has confirmed this picture. In particular, it encountered a belief in some quarters that there was no need for fund managers to consider intervention in investee companies, as it was not part of their role to do so. When such action did occur, it was often after concerns had persisted for some time.

14. The Government views this with concern. If a course of action is in the best interests of fund managers' clients, then both under financial services legislation and general common law, it is plainly the duty of fund managers to take that course of action. It may well be that in specific circumstances such intervention is not in the best interests of clients, in which case fund managers should not intervene. But the issue needs to be considered on a case by case basis. A blanket policy of non-intervention is not compatible with fund managers' responsibilities to clients. Such a policy will result in beneficiaries' money continuing to be invested in underperforming shares, when action by the fund manager could have improved their financial performance. This situation is plainly not in beneficiaries' best interests.

The Government's objective

15. The activity which the Government wishes to encourage is appropriate and informed intervention, whether using the mechanism of voting or not. Given the important roles of both pension scheme trustees and fund managers in this area, it wishes to include both groups in the scope of the proposals.

16. Clearly the role of fund managers and pension scheme trustees differ. It follows that the way in which they will need to be involved in active shareholding will also differ. Where trustees have delegated investment management decisions to a fund manager, they might expect that the fund manager would take on most of the practical role of, for example, engagement with companies and decisions to vote shares. There will also be a role for the custodian who will hold the assets and carry out votes on the fund managers' instructions. But this does not mean that the trustees can delegate their responsibility for ensuring that the duty to active shareholding is carried out. They would need to ensure that their relationship with their fund manager, including the manager's mandate and monitoring arrangements, are framed to ensure that their statutory duty is met.

17. The Government shares the view of the Myners review:

    "*…The review does not believe that the Department of Labor principle means compulsory voting, nor is it the review's intention that managers should invariably exercise votes on all their shares, however unthinkingly. But voting is one of the central means by which shareholders can influence the companies in which they have holdings, and the review believes that a culture in which informed voting was more universal is very much to be desired.*"

18. Nor does the Government wish to make intervention compulsory regardless of circumstances - for example, by creating a duty to intervene even where the costs would exceed the benefits. This would not be right.

19. Legislative change cannot of itself create a culture of appropriate and informed intervention. But it can facilitate its creation – in particular, by clarifying the duty of pension funds and their fund managers in this regard. The Myners' review identified a series of factors that made fund managers reluctant to intervene. A duty to do so would provide a counterweight to these factors.

20. As set out below, it could be argued that the duty to intervene where appropriate already exists in UK law. But it is clear from the Myners review that the existence of this duty is not accepted or perhaps understood very well among institutions and their managers. There is therefore still benefit in enacting such a duty.

The proposals

21. In line with the recommendation of the review, the Government is proposing to impose, on all those involved in pension fund management,

an express statutory duty to use shareholder powers to intervene in investee companies where this is in a pension scheme's best interests.

Coverage

22. The proposal of the Myners review was for the new duty to apply to fund managers managing pension fund assets. A number of responses to the Government's consultation on the Myners Codes of Investment Principles observed that the ultimate responsibility for activism lay with trustees, and that therefore the duty should apply to them.

Q1. The Government is minded therefore that the activism duty should apply to trustees as well as fund managers, but would welcome views on this approach and any other impressions.

23. There is then a separate issue of how non-pension monies being managed by fund management businesses should be treated. Fund management businesses typically manage a range of funds – pension funds, collective investment scheme monies, life insurance funds and so on – and the pension fund element is in many cases not separately identified. The Government believes that in practice, it would be desirable for the same requirement to apply to all these funds: namely, that the fund manager should intervene where it is in the best interests of the beneficiaries of the fund concerned. How exactly this is best achieved in the drafting of any legal discussion is less clear. Precisely because fund managers do not generally distinguish between pension fund and other monies, there may be no need to include non-pension fund clients explicitly in the scope of the requirement. Alternatively, it may be that this approach would lead to confusion.

Q2. Taking the above into account, the Government would be interested in the view of respondents on an appropriate approach as to which funds are included in the duty.

24. The duty will apply in respect of both defined benefit and defined contribution occupational pension schemes, regardless of whether or not members have any discretion as to how monies are invested. Similarly, the duty will also apply equally to fund managers and insurance companies in respect of the investment of assets held under personal pension schemes and other pension arrangements. The duty will apply irrespective of the size of a scheme[1], subject to some possible minor

[1] The costs of actively engaging with companies and exercising shareholder votes for *small* schemes may well mean that in practice, taking no action is usually in members' best financial interests for such schemes.

exceptions, and the new statutory duty should apply equally to all persons responsible for the investment of the assets of any type of retirement benefits scheme.

25. It is proposed that the duty should not apply to a scheme where all members are trustees of the scheme and those trustees invest the scheme's assets directly.

Proposed duty

26. Subject to views, it is proposed that the duty will be framed in the following way:

"Any person who is responsible for the investment of the assets of a retirement benefits scheme must, in respect of any company or undertaking (wheresoever resident or incorporated) in which they invest such assets, use such rights and powers as arise by virtue of such investment in the best interests of the members and beneficiaries of such scheme".

27. It is proposed that the new duty will override any contrary provision in a scheme's rules but may be varied in a fund mandate in so far as a fund manager is instructed to comply with a specific trustee voting policy.

Enforcement / Remedies for Breach

28. In order for the new statutory duty to have the desired effect and to provide additional legal certainty, it is proposed to provide expressly, that breach of the new statutory duty may be the subject of civil proceedings in the same manner as a claim in tort.

29. It may also be appropriate for funds to disclose their approach to active shareholding and arrangements for ensuring that the statutory duty is met. This might be done in the Statement of Investment Principles or the scheme report and accounts.

Q3. The Government would welcome views on how best to disclose compliance with the new law.

30. The Financial Services Authority may wish to consider covering arrangements for active shareholding as one of the issues they require to be dealt with in investment management contract terms.

Consequences of Proposals

Financial Services Legislation

31. Some fund managers may not consider themselves best qualified to advise on the exercise of voting or other rights in relation to shares in investee companies, and may therefore wish to outsource the advisory function.

32. The manner in which outsourcing arrangements are made may be impacted by financial services legislation, in particular, the Financial Services and Markets Act 2000 and its delegated legislation. Advice given by third parties on whether, for example, to support or boycott a rights issue may be classed as advising on investments, whilst any delegation outwards of discretion on how to vote might fall within the managing activity. The Financial Services Authority has agreed to review its Handbook of rules and guidance to ensure compatibility with the greater degree of activism anticipated by this consultation.

Conflicts / Chinese Walls

33. The Government recognises that conflicts are likely to arise, for example between the requirements of voting policies of different schemes for whom a fund manager acts. This however, is a situation which may already occur in a number of situations, and so is arguably no more difficult to address than current potential conflicts between fund manager and client, or between different clients. It is accordingly not proposed to deal with this issue as part of the proposed legislation.

Regulatory concerns: Insider Dealing

34. The Government is aware that concerns have been expressed that the imposition of a requirement on fund managers to take a more active role in intervention in the companies whose securities are included in any relevant managed portfolio may leave the fund managers exposed under insider dealing legislation. An example of this concern has been that, if fund managers were to become actively engaged in the management of investee companies, then they might become party to inside information, which might in turn restrict them from dealing on the shares of those companies.

35. While this is clearly an issue which fund managers need to consider, there are a number of ways in which they can deal with it.

- Not all intervention requires the acquisition of insider information.

- Fund managers can put in place the appropriate procedures to isolate information received in this way from their buy/sell decision making process. This is an issue already faced by banks who are both lender to and shareholder in a company, particularly as regards information received when a company gets into financial difficulties.

- The implication of this argument is that fund managers begin from a position of being entirely free to sell all the shares of the company concerned if they wish. This is far from true in practice. As the Myners' review identified, in practice, a zero holding in a company may well not be possible because it would involve too great a departure from index benchmarks or because of the price impact.

Costs

36. The Government recognises that compliance with the new statutory duty may impose additional costs on fund managers. However:

- Some fund managers already engage in this sort of activity.

- Even where fund managers do not, they already expend considerable effort in analysing and understanding investee companies. This new duty merely requires them to act when it is appropriate to do so. While this will clearly involve additional cost, it will often not be major.

- Most importantly, as argued above, intervention, where in the client's interests, should already be part of fund managers' normal activities. It would be inappropriate to argue that concern about cost should justify fund managers failing to act in their clients' best interests.

- If these costs exceed the benefits of intervention, then clearly intervention should not take place.

Annex A

EXISTING DUTIES OF PENSION SCHEME TRUSTEES/FUND MANAGERS

The following does not attempt to provide a comprehensive analysis of the current legal requirements which apply to pension scheme trustees and fund managers with regard to the investment of scheme assets and shareholder activism. A summary of the position is however, provided below.

Where pension scheme trustees are responsible for investing pension scheme assets, they are subject to a duty to the beneficiaries under their scheme to exercise the degree of diligence that an ordinary prudent man would take, if he were minded to make an investment for the benefit of other people, for whom he felt morally bound to provide. Where investments are made in company shares, arguably this includes a duty to exercise any votes and use shareholder powers in a way to maximise the value of an investment for the benefit of the beneficiaries of their scheme.

In most cases, because of the requirement under financial services legislation to be authorised to conduct investment business, investment decisions are delegated by pension scheme trustees to authorised fund managers. In this situation, it is arguably again already a requirement of that relationship that shareholder powers are exercised in a way to maximise the value of investments. It is also arguable that the same requirement applies to providers of personal pension schemes either under contracts with or as part of the duties owed to members.

However, the Myners' review also found that in practice, many fund managers did not in fact regard it as their part of their work to intervene in companies citing a variety of justifications.

Annex B

ERISA

BACKGROUND

The Employment Retirement Income Security Act 1974 (ERISA) is a large piece of legislation which regulates many aspects of employee benefit provision. It was introduced to provide uniform minimum standards throughout US as to the treatment of beneficiaries of pension schemes and the protection of their rights and pension scheme assets.

THE FIDUCIARY DUTY OF CARE

Section 404(a)(1) of ERISA provides for anyone who is a fiduciary (trustees, scheme administrators, investment managers etc.) to have certain express duties. Central to these are the obligations to discharge duties in respect of a scheme:

- Solely in the interest of members and beneficiaries.
- For the exclusive purpose of providing benefits to members and beneficiaries and defraying reasonable expenses of administering the scheme.
- With the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man, acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.

SHAREHOLDER ACTIVISM

ERISA does not provide an express obligation on trustees and fund managers to exercise their rights as shareholders. This obligation rather forms an intrinsic part of the wider fiduciary duties outlined above. The US Department of Labor (DOL) has, as the body tasked with enforcing compliance with the statutory fiduciary duties, over a period of time, issued guidance, in the form of various letters and bulletins as to the scope of and steps which should be taken to comply with the fiduciary duties.

The latest guidance regarding the requirement for shareholder activism is contained in DOL Interpretative Bulletin 94-2. This brings together and expands on previous guidance.

The essence of the guidance is that although within the corporate structure, the primary responsibility to oversee corporate management falls on the corporation's board of directors, active monitoring of and communication with corporate management and the exercise of shareholder votes is consistent with a fiduciary's obligations where the fiduciary concludes that there is a reasonable expectation that such activities by a scheme (either by itself or with other shareholders), are likely to enhance the value of a scheme's investment, after taking into account the costs involved.

Typical actions of fund managers will include considering a variety of aspects of companies in which shares are held, including:

- The independence and expertise of nominees to the board of a company.
- The appropriateness of executive remuneration.
- Financing and capitalisation issues.
- A company's M&A policy.
- A company's long term business plan.

SUMMARY OF QUESTIONS

Q1. The Government is minded that the activism duty should apply to trustees as well as fund managers, but would welcome views on this approach and any other impressions. (Para 22)

Q2. The Government would be interested in the view of respondents on an appropriate approach as to which funds are included in the duty. (Para 23)

Q3. The Government would welcome views on how best to disclose compliance with the new law. (Para 29)