

# No action no option

A new era for active share ownership?

## Summary

For almost a decade legal and best practice standards have encouraged institutional shareholders to be active owners of capital. In the wake of the economic crisis this message is being re-emphasised by Government and other stakeholders. As the investment industry re-examines the respective roles and responsibilities of market participants the relationship between companies and their shareholders will no doubt receive further attention. It is likely that pension funds will come under increasing pressure to use their shareholder rights to advocate improved corporate governance.

**We believe that active ownership can help enhance long-term shareholder value and are therefore supportive of pension funds being more active.** However, in practice, most funds delegate investment management to external managers and in so doing typically delegate their shareholder rights. We therefore encourage trustees to work with their investment managers to develop an active ownership approach where appropriate.

## Calls for reform

Corporate governance failures have been cited as one of many factors contributing to the collapse of the financial system. In particular, poor alignment of incentives and remuneration as well as ineffective shareholder oversight and challenge of company boards. In response to these failures there have been calls for corporate governance reform.

The OECD believes that “the financial crisis has revealed severe shortcomings in corporate governance. When most needed, [it] often failed to provide the necessary checks and balances that companies need in order to cultivate sound business practices”<sup>1</sup>.

As part of its strategic response, the OECD is working with governments and industry to develop and put in place more effective corporate governance standards, including improvements to the OECD Principles of Corporate Governance.

On a similar note, when addressing the National Association of Pension Funds, Hector Sants, Chief Executive of the UK's Financial Services Authority, said "A lesson for you from this crisis must be that greater interrogation of how well a company is managed and the adequacy of its risk controls are all material factors fundamental to investment management".

The Financial Services Secretary, Lord Myners, has also challenged pension fund trustees to take governance more seriously, stating that "trustees owe it to their pension holders to challenge effectively where necessary... and you should not underestimate the long-term financial value of insisting on sound governance"<sup>2</sup>.

**“ Disengaged investors lead to ownerless corporations and the risk of unaccountable executives and boards running amok. It carries with it substantial economic risk. ”**

Lord Myners,  
NAPF Investment Conference 2009

Despite apparent governance weaknesses revealed by the crisis, the UK's corporate governance model has often been considered amongst the most advanced in the world. Some argue the problem lies not in the rules themselves but in their application. The Financial Reporting Council's (FRC) combined code on corporate governance sets the standard for publicly listed companies and works on a 'comply or explain' basis. As providers of

capital, shareholders should hold boards accountable to ensure companies are managed in the best long-term interests of beneficiaries. It is the relationships between company management, boards and shareholders which, in some cases, have failed.

### **What does the future hold?**

We believe that pension funds are likely to come under growing pressure to be more engaged shareholders and renewed effort on the effective implementation of existing best practice standards is already in train.

- The recently updated Myners Principles reinforce the need for responsible share ownership. These principles sign-post the Institutional Shareholders Committee (ISC) Statement which recommends that investors should monitor company performance and intervene where they have concerns regarding corporate strategy, performance or governance. Typical intervention tools include engagement with company management, voting at AGMs and EGMs or lodging shareholder resolutions. Whilst these best practice standards are entirely voluntary, pension funds are expected to provide an explanation for non-compliance.
- The Walker Review of corporate governance in the banking sector could have market-wide impact on best practice standards. Commissioned by the Chancellor, the review is examining the operation and effectiveness of boards, how they interact with other parties (such as institutional investors) and how they can

provide more effective oversight of company management. The resulting recommendations could be reflected in future iterations of the combined code on corporate governance, a review of which was announced by the FRC in March 2009.

- Greater transparency could also feature more heavily going forward. For example, the Companies Act 2006 contains reserve powers which would require public disclosure by institutional investors of how they vote on company resolutions. The Government has stated that it will only enact these powers if a voluntary regime fails to improve disclosure. It is possible, however, that recent governance failures could stimulate the Government to opt for a mandatory approach. Scrutiny of shareholder activity already exists by way of numerous surveys which monitor, and in some cases benchmark, pension funds' active ownership, the results of which are made public<sup>3</sup>.

## What should trustees do?

Active ownership principles tend to be most aligned with equity-based strategies that have a medium or long-term investment horizon, such as passive, or certain active strategies, which can also include equity based hedge fund strategies.

Therefore, with respect to these types of mandates we suggest trustees consider the following actions:

1. Make an explicit commitment to active share ownership and document how this will be implemented in the scheme's Statement of Investment Principles (SIP).

2. Communicate this commitment to the scheme's external managers, making it clear that the pension fund takes governance seriously.
3. Clearly set out the pension fund's expectations of external managers with regard to active ownership. This should be formalised in some way, possibly in investment management agreements or in a scheme's SIP.
4. Monitor manager performance against the trustees' active ownership requirements. This should form an integral part of the ongoing evaluation of manager performance.

## Active Ownership Watch

Watson Wyatt has dedicated research expertise focused on sustainable investment and active ownership. For some time we have been evaluating managers' active ownership practices and now provide a manager monitoring service called Active Ownership Watch. Through direct contact with managers we assess their active ownership policies, procedures, resources, voting and engagement activity and reporting systems. We highlight areas of strength, weakness and also any inconsistency between managers used by the pension fund, enabling trustees to identify areas for improvement.

## Further information

No action should be taken on the basis of any article without seeking specific advice. If you would like to discuss any of the areas covered in this paper or would like to know more about Active Ownership Watch, please contact your usual Watson Wyatt consultant or

**Jane Goodland**

+44 (0) 207 227 2411

[jane.goodland@watsonwyatt.com](mailto:jane.goodland@watsonwyatt.com)

<sup>1</sup> [www.oecd.org/corporate](http://www.oecd.org/corporate)

<sup>2</sup> National Association of Pension Funds Investment Conference 2009

<sup>3</sup> These includes surveys by UK Sustainable Investment and Finance (UKSIF), National Association of Pension Funds (NAPF), lobby group FairPensions, and news group Investment and Pensions Europe (IPE).

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