Kay Review of Equity Markets - TUC Response

TUC Response to Kay Review of UK Equity Markets and Long-Term Decision Making
Introduction

The TUC welcomes this opportunity to give evidence to the Kay Review of Equity Markets and Long-Term Decision Making (henceforth the Review). We believe that the Review is covering issues of key importance both to the long-term success of UK companies and to investors such as pension funds and their beneficiaries. The TUC represents interests in both constituencies. We represent over six million workers in 55 unions, many of whom work in companies and are directly affected by the priorities and pressures of board room decision making. At the same time, workers’ retirement savings make up a significant proportion of total UK investment funds, and the TUC represents workers across all sectors of the economy who have savings in occupational and personal pension schemes. The TUC coordinates a network of over 1,000 trade union pension fund trustees, for whom hold an annual trustee conference and other events and seminars and to whom we circulate a quarterly newsletter. Our response to this Review draws on our experience of representing the interests of these overlapping constituencies.

1. Whether the timescales considered by boards and senior management in evaluating corporate risks and opportunities, and by institutional shareholders and asset managers in making investment and governance decisions, match the time horizons of the underlying beneficiaries.

We would particularly welcome evidence on:

c. how companies review investment in intangible assets (e.g. corporate reputation, workforce skills);

The UK Commission on Employment and Skills recently published a research report on the impact of intangible assets on productivity, the main conclusion of which is that ‘intangible assets have a significant, positive association with productivity’.

However, the TUC remains concerned that too few companies take a strategic approach to training. Training budgets tend to be spent disproportionately on more highly skilled staff and are frequently regarded by companies as a cost rather than an investment in future productivity gains.

The TUC has for some time called for companies to be required to set out a short summary of their training provision in their annual reports and for this to be more tightly linked to how tax relief on training is applied. The TUC believes that the government should review the current arrangements for tax relief for work-related training, and would support greater priority being given to accredited training such as apprenticeships. A recent policy paper by unionlearn estimates that the total cost of this relief to the Exchequer is in the region of £5 billion per annum, but

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little information is available on how it is being used by those employers that qualify for it.

Other organisations have called for similar measures. For example, the NIACE report “Learning Through Life: Inquiry into the Future for Lifelong Learning” recommended the following:

- There should be a clearer set of standards for gauging employer engagement with learning. Claims to corporation tax relief for training should be linked to these standards.
- Data on training performance and expenditure, including on learning leave, should be published in the organisations’ annual accounts of publicly quoted companies.

**d. what timescales are used by equity investors, and in particular institutional investors such as pension scheme trustees, who appoint fund managers in determining investment strategy.**

Based on our experience, the TUC believes that it can be difficult for pension fund trustees to focus sufficiently on long-term issues, including long-term investment strategies and returns. This is partly because of the nature of the information that fund managers provide to pension fund trustees, which generally focuses on quarterly and annual fund performance.

Paul Myners highlighted the problem of short-term investment horizons of fund managers and pension fund trustees in his report on institutional investment in the UK in 2001. The NAPF reviewed the Myners principles in 2007 and concluded that while pension funds had made progress on setting explicit mandates, including timescales, less progress had been made on the issue of timescales, with some pension scheme respondents commenting on the short termist nature of mandates.

Regulatory requirements may contribute to this situation. The Pensions Regulator (TPR) has made it clear that pension fund trustees should monitor the funding situation of their pension funds carefully and requires pension fund to undergo a full funding analysis every three years. Pension fund payments into the Pensions Protection Fund are dependent on scheme funding levels. The fact that valuations are based on mark-to-market accounting means that short-term movements of share prices have a real and significant impact on pension schemes and their PPF payments, even when those share prices are not necessarily a good reflection of underlying company value and long-term performance. This combination of funding pressures, mark-to-market accounting and relatively short-term information from fund managers can make it difficult for pension fund trustees to focus sufficiently on longer-term investment returns and strategies.

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3 Institutional Investment in the UK: a review, H.M.T., 2001
4 Institutional Investment in the UK: six years on, NAPF, November 2007, page 25
The TUC recognises that tackling this situation is challenging and complex. It is clearly right that pension fund trustees should pay sufficient attention to funding levels and trustees, especially those tackling deficits, cannot focus only on long-term returns and strategies to the exclusion of the short and medium-term. However, the TUC does believe that reports from fund managers to clients such as pension funds need to put a greater emphasis on long and medium term returns than is currently the case. We propose that fund managers should be required to report to clients on returns over the past twenty, ten and five years on an annual basis, and that the Review could usefully consult on the form that such reporting should take.

The TUC believes that it is particularly important that comparative data in which a fund’s performance is measured against a chosen benchmark is looked at on a long to medium timescale, rather than a short-term basis, to avoid the worst pitfalls of herding behaviour and the consequent devaluation of assets that this creates. Research has shown that the tendency towards institutional ‘herding’ does protect short-term returns, but does so at the expense of long-term returns.

We would also welcome a review of mark-to-market accounting and whether there are potential alternatives that could enable pension fund valuations to reflect the underlying strength of assets and investments, rather than the prices of assets on a particular day. This is particularly important in the aftermath of the financial crisis which has led to increased stock market volatility with extreme fluctuations in share prices.

2. How to ensure that shareholders and their agents give sufficient emphasis to the underlying competitive strengths of the individual companies in which they invest.

We would particularly welcome evidence on:

a. how equity analysts and asset managers assess the competitive advantages of companies;

b. the extent to which trading on equity markets is guided by analysis of underlying corporate performance, and the extent to which it is driven by analysis of short-term market trends.

The TUC’s experience of raising employment issues with asset managers suggests to us that insufficient attention is paid by asset managers and analysts to underlying factors that have a significant impact on company performance, including issues such as the quality of employment relationships.

The TUC carries out an annual Fund Manager Voting Survey, which targets major fund managers asking for information on how they voted on key items at company AGMs and on policies and processes relating to engagement. Our most recent Survey, attached with this response, asked about policies and engagement on

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labour issues. Responses suggested that around half of respondents did not have explicit policies to inform engagement and voting on labour issues. The extent of engagement on labour issues varied widely, with four respondents saying they had carried out no engagement on labour issues over the past year, seven stating that the information was not available, and one stating that the information was confidential. Of the eight respondents that had engaged, one stated that it had engaged with three companies, four put the number of companies between 10 and 20, one had engaged with 33, another with 97 (across a range of labour-related topics) and another 420. (The large disparity in numbers might be due to the definition of engagement, with some perhaps including letters sent to companies (often to an entire sector) whilst others include only face-to-face meetings.) Overall, with some notable exceptions, it would appear that many fund managers are insufficiently concerned about employment practices in investee companies to raise the issue with company management.

We believe this is in part because fund managers are insufficiently aware of the strong linkage between good quality employment relationships and company financial performance (for more information on this see, for example, evidence presented in Engaging for Success: enhancing performance through employee engagement by David MacLeod and Nita Clarke, July 2009). In addition, some asset managers appear to feel that issues such as employment relationships are not really their concern, and that their role is to focus on financial indicators.

In addition to a lack of awareness of issues critical to long-term company success on the part of asset managers, the TUC believes that the emphasis on comparative fund manager performance makes it more difficult for fund managers to take decisions that go against what the rest of the market is doing. This means that if there is a general tendency to take decisions based on short-term market trends, it is hard for individual fund managers to buck this trend in case it has a negative impact on their comparative short-term performance ratings.

3. Whether the current functioning of equity markets gives sufficient encouragement to boards to focus on the long term development of their business.

We would particularly welcome evidence on:

a. whether changes in reporting obligations have influenced the perspectives and timescales of managers and boards, and whether these changes in perspectives and timescales help or hinder long-term decision making;

Quarterly reporting is often said to promote short-term decision making of both company boards and investors. For example, Rathbone Unit Trust Management Income fund manager Carl Stick, commenting on the average holding period for stocks in the UK and US falling from 10 years in the 1940s to nine months in 2010, said “much of my industry is only interested in taking a bet on the next two
quarters of news reporting [from companies], which is absolutely crazy. We are all turning to quarterly reporting, that is why the industry is so short term."

The TUC is sympathetic to the argument that if information is being produced for asset managers on a quarterly basis it is hard to see how this can fail to encourage both boards and investors to focus on the short-term. However, the TUC believes that quarterly reporting is also a symptom of short-termism, as well as contributing to the problem. We believe that this is exacerbated by a lack of long-term information on company performance which could act to counter-balance the short-term information made available to investors. We would recommend that the Review investigates the introduction of requirements for company reporting on long-term performance.

**c. whether publicly traded companies pay too much attention (or feel obliged to pay too much attention) to short-term fluctuations in their share prices;**

There is considerable evidence that directors of publicly traded companies do feel under pressure to maintain their company’s share price. This can lead them to undertake short-term strategies to boost their share price even when this will not be conducive to long-term company performance. For example, Andy Haldane in Patience and Finance argues that there is 'strong evidence of high and sticky dividend payout ratios, almost irrespective of profits. Moreover, dividends appear to be becoming stickier over time.'

One reason that companies feel under pressure to maintain their share price is that a low share price leaves them vulnerable to a hostile takeover. Because of different takeover regimes, UK companies are uniquely vulnerable to hostile takeover in comparison with those based in other European countries or the US. The recent amendments to the Takeover Code should go some way to address this, but the TUC believes that without more fundamental reform to the market for corporate control, company directors will continue to prioritise the maintenance of a high share price in order to protect their company’s continued independence over strategies to boost long-term, organic growth.

The TUC believes that the current takeover regime should be reformed so that mergers and takeovers are subject to a long-term company interest test. We believe that the best way to do this would be through the establishment of a Mergers and Takeovers Commission that would operate at arm’s length from Government and whose role would be to assess whether or not proposed takeovers were in the long-term interest of the target company. Alternatively, the remit and membership of the current Competition Commission could be adapted to encompass a wider role

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6 Investment Week, February 2010

than its current focus on competition. In either scenario, an appropriate referral system would need to be developed.

4. **Whether Government policies directly relevant to individual quoted companies (such as regulation and procurement) sufficiently encourage boards to focus on the long term development of their businesses.**

We would particularly welcome evidence on:

**a. whether government policies encourage undue focus on cost cutting, or otherwise damage the ability of firms to engage in long-term investment and the building of sustainable competitive advantage;**

The TUC has been closely involved in developments relating to procurement policy. Our involvement began when we submitted evidence to the Office of Government Commerce (OGC), which was then part of the UK Treasury, on the transposing of the EU Procurement Directives into UK law. We submitted a number of written papers, making the case for the full implementation of these Directives, including opportunities for procurement policy to promote social, environmental and employment objectives such as skills training, sustainability, equality and help for the unemployed and other excluded groups of workers.

The TUC, in common with other trade union centres, prioritises both the quality and quantity of work, for our members and the wider workforce. We believe, for example, that many companies can and must do more to improve the skills of their workforces. We further believe that this not only enhances the life chances of their own workforces, but at the macro level, increases the level of skills of the workforce overall. Ultimately, British industry would be more competitive if procurement were used to pursue the skills agenda. Since more than £220bn of public money is spent procuring goods and services, it is clear to see that the widespread use of procurement contracts to drive up skills could deliver a step-change in the skills of the workforce.

A similar situation exists with regard to the environment. Public authorities can commission environmentally-friendly buses, for example, which contribute both to lowering greenhouse gas emissions and to developing green technology, thereby giving the company and country a competitive edge in green transport solutions of the future.

Legal force for social clauses in procurement contracts can be found in Recital 33 of the EU Public Sector Directive. This states:

“Contract performance conditions are compatible with this Directive provided that they are not directly or indirectly discriminatory and are indicated in the contract

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8 For more information on this proposal, please see TUC, Mergers and Takeovers - Proposals for Reform, June 2010

9 Policy through Procurement Action Plan, Office of Government Commerce, January 2010
notice or in the contract documents. They may, in particular, be intended to favour on-site vocational training, the employment of people experiencing particular difficulty in achieving integration, the fight against unemployment or the protection of the environment. For instance, mention may be made, amongst other things, of the requirements - applicable during performance of the contract - to recruit long-term job-seekers or to implement training measures for the unemployed or young persons, to comply in substance with the provisions of the basic International Labour Organisation (ILO) Conventions, assuming that such provisions have not been implemented in national law, and to recruit more handicapped persons than are required under national legislation."

Of course, when a procurement contract requires a minimum amount of skills training or a commitment to the environment, the cost of meeting that contract is likely to be higher than if no skills training was undertaken or of the cheapest solution was found, irrespective of how sustainable it was. In other words, the argument for social, environmental and employment clauses in contracts is pitted against the case for lowest cost. At times of pressure on short-term budgets, the political considerations of the UK Government have often seemed to favour lower costs rather than higher standards. The fact that the UK Treasury has always tended to take a short term view of finances, meaning that spending money on skills is likely to be seen as a cost rather than an investment, has underlined this tendency.

It could be argued that the financial crisis, which has increased pressure on national budgets, means it is more important that procurement policy focuses on low costs. However, from a UK perspective, the financial crisis has also led to calls for a rebalancing of the economy. A recognition that too much emphasis was in the past given to financial services, to the detriment of high technology and manufacturing industries, has kindled a debate about the need for a renaissance in the UK’s manufacturing sector. If this is to come about, increasing skills and building more sustainable products are vital for the UK to develop and maintain a competitive edge.

In the TUC’s view, therefore, the financial crisis strengthens, rather than weakens, the case for social, environmental and employment clauses in procurement contracts.

The TUC is very concerned about developments in UK procurement policy since the May 2010 General Election. Our principal concern is that the Office of Government Commerce has moved from the Treasury to the Cabinet Office. This appears to demonstrate that the Coalition Government does not recognise the link between procurement policy and economic objectives, most obviously economic growth. What is more, the OGC is now part of the Efficiency and Reform Group, whose emphasis is on driving down the costs of procurement and taking a tough stand on inefficiency and waste. While, of course, we would all wish to see waste eliminated, such language has usually marked a drive to seek procurement at lowest cost, where the importance of standards are diluted.
The TUC strongly believes this to be the wrong priority and we call on the Coalition Government to recognise the importance of procurement in driving growth, innovation, skills and employment.

b. whether government policies aimed at facilitating long-term investment by companies have been effective and whether there are other ways Government could support long-term business growth.

The Companies Act 2006 codified directors’ duties for the first time in the UK. Documentation from the Company Law Review, whose recommendations formed the basis of the Companies Act 2006, and Parliamentary exchanges that took place as the Bill passed through Parliament, both show that one aim of the new duties was to ensure that directors were encouraged to balance short-term aims with long-term strategies. This is addressed clearly in section 172 which stipulates that directors are required to ‘have regard…to (a) the likely consequences of any decision in the long-term’.

Based on union experiences of representing the interests of workers employed by companies, the TUC does not believe that the new directors’ duties have had any significant impact on company prioritisation and decision making. This experience is backed up by research; a recent ACCA study found that interviewees from the corporate sector believed that directors’ duties amounted to maximising share price in the short-term. What directors’ duties require of directors in reality is almost irrelevant if this is how directors interpret their duties.

The TUC believes that section 172 should be amended to make directors’ primary duty to promote the long-term success of the company, rather than prioritising shareholders’ interests as at present. Serving the interests of shareholders and the different stakeholder groups included in Section 172 should be secondary to this central aim. This would be closer to the original intention of how the new directors’ duties set out in the Companies Act 2006 would operate. A possible formulation would be:

‘The directors of the company are required to act in good faith to promote the long-term success of the company, and in so doing, should have regard to the need to:

i) deliver fair and sustainable returns to investors

ii) promote the interests of the company’s employees

iii) foster the company’s relationships with suppliers, customers, local communities and others, and

iv) take a responsible approach to the impact of the company’s operations on the environment.’

5. Whether Government policies directly relevant to institutional

shareholders and fund managers promote long-term time horizons and effective collective engagement.

We would particularly welcome evidence on:

a. whether pension regulation, insurance regulation, supervision of charitable endowments and regulatory requirements for asset managers lead to excessive emphasis on benchmarking and on short-term performance measurement;

NB: please note that the arguments below relating to pension fund diversification, pooled funds, defined contribution schemes and retail investment funds are also relevant to questions 6 and 8.

As argued above in response to question 1d, the TUC is concerned that the timescales of fund managers’ reports to clients and funding requirements for pension funds can encourage an emphasis on short-term performance of their fund managers. As already stated, we would suggest that this could be addressed by introducing reporting requirements on long-term fund performance, rather than reducing monitoring of funding levels.

As also already mentioned in response to question 1d, the TUC is particularly concerned about potential impact of comparative reports on fund manager performance. We are concerned that comparative reports of fund manager performance can encourage herding and make it harder for fund managers to assess companies on the basis of their propensity for long-term value creation as opposed to immediate shareholder returns, for fear of lowering their comparative ratings. We believe that comparative performance reports should focus on medium-term and long-term performance.

Pension funds are required by law to maintain a diversified portfolio, avoiding reliance on particular assets in order to reduce risk. While it is clearly important for pension fund investments to avoid a situation where they are unduly reliant on a particular asset or asset class, the drive for diversification has also contributed to increased intermediation and complexity in pension fund investments. As well as creating direct costs in the form of charges, complexity and intermediation can make it harder for asset owners to monitor their assets effectively, including on the issue of timescales. Recent years have also seen the development of different types of complex pooled products which combine investments across different asset classes, some of which are not very transparent about exactly what they are invested in at any one time. This makes it difficult for asset owners to monitor the investment strategies that are being pursued on their behalf, including in relation to any companies whose shares they hold via these products.

Many small pension funds invest entirely in pooled equity funds in order to keep their costs low. While some pooled funds allow beneficiaries to determine the voting policy followed on their behalf, others do not. We also know of one case where a fund manager has allowed one client to vote its share of a pooled fund according to its own policies but refused the request of another client to do the same.
The TUC Fund Manager Voting Survey 2011 asked respondents how they dealt with clients in pooled funds that wished to issue their own voting instructions. Three respondents stated that such a situation had never arisen. Of these, one stated that it would be able to facilitate it, but another stated it was very administratively complex. Another seven respondents stated that they were able to apply client voting instructions to a pooled fund, though one stated that this may depend on the size of the mandate. The method mentioned by two respondents for achieving the override was to vote a pro-rata amount of the fund’s shares in line with client wishes. Four respondents stated that clients were not able to over-ride the fund voting policy.

The fact that some fund managers facilitate clients in pooled funds issuing their own voting instructions shows that it is perfectly possible for this work, and the TUC believes that all investors in pooled funds should be able to issue their own voting instructions if they wish. The TUC believes that this should be included in the Stewardship Code. If this does not bring about sufficient change, then further public policy measures would be necessary.

There is an urgent need to address the deficit in relation to member voice in contract based defined contribution pension schemes and retail investment products, including personal pension schemes and insurance products. While the investment chain works imperfectly in relation to defined benefit pension schemes, the problems are far worse for the majority of defined contribution schemes that are contract based and have no provision for member input and voice. This is a major problem in relation to a whole range of areas, including critical issues such as contribution rates, the design of default schemes, charges, member communications and so on. It is also a problem in relation to effective engagement, as scheme members – the ultimate beneficiaries of the investments – have no way to influence the engagement and voting strategies that are followed on their behalf and frequently do not even receive information on these areas. Given the increased coverage of defined contribution pension schemes, the majority of which are contact based, it is imperative that this deficit in member input is tackled. The TUC believes that in relation to defined contribution pension schemes, public policy should support the development of collective, trust based schemes, rather than contract based schemes.

These problems of lack of member input and information are mirrored in relation to personal pensions and other retail products. While it is clearly not possible for all individual members of a personal pension scheme or insurance product to set their own individual voting and engagement policy, the TUC does believe that some degree of input and choice must be offered on these issues to individual investors. This could be done through developing a range of voting and engagement products from which clients could choose across different investment products. In-house options could be supplemented by those offered by external proxy voting organisations. Without developments of this sort, it will not be possible for member demand to be transmitted effectively via large parts of the investment chain, including on issues relating to voting, engagement and investment strategies.
b. whether the broader regulation of equity markets has an impact on the investment timescales of market participants;  

We have already set out in response to question 3c our concern that the market for corporate control drives company directors to seek to maintain high shareholder returns even when not justified by company performance.

We would point to the complex issue of the relationships between different actors in the investment chain as having a major impact on the investment timescales of market participants. This issue is explored in more detail in response to questions a above, question 6 below and elsewhere in this response. We believe that a lack of clarity on what is expected of the different parts of the investment chain in relation to long-term investment that contributes to the problem of short-term investment timescales of market participants. We would support the revision of the Stewardship Code to clarify the responsibilities of all the different participants in the investment chain in relation to stewardship, including asset owners and consultants.

c. whether the regulation of contact between companies and investors is an obstacle to effective engagement.

Anecdotally, some fund managers do cite concerns over acting in concert as a reason against undertaking collective engagement. Equally, the TUC has heard it suggested by others that this is more an excuse for inaction than a legitimate obstacle. It is certainly the case that collective engagement involving different investors has on some occasions taken place within the existing rules on acting in concert. However, in so far as some fund managers do genuinely believe that rules on acting in concert prevent them from engaging collectively, then there is at the very least a need to address this perception.

6. Whether the current legal duties and responsibilities of asset owners and fund managers, and the fee and pay structures in the investment chain, are consistent with these long-term objectives.

Under the UK’s corporate governance system, shareholders have a privileged position. Shareholders are entitled to elect directors - now annually - at company AGMs; vote on remuneration reports, although the vote is only ‘advisory’; vote on shareholder and other resolutions at AGMs; and convene Emergency General Meetings. Directors are required to serve shareholder interests (though please see our recommendations for reform under 4b above).

This system is based on an assumption that there is a convergence of interests between shareholders and the company (and its other stakeholders). However, this convergence of interests only holds in practice if shareholders are committed to investing in the company on a long-term basis and their prime financial interest in the company is the ability to receive dividend payments over time. If, however, an investor is a short-term share trader whose prime financial interest in the company is to sell their shares at a higher price than they bought them, their interest will be in short-term strategies to raise the share price, rather than long-term strategies to invest in organic growth. In this case, their interests will not coincide with those of company stakeholders such as employees and suppliers, nor, very significantly,
with those of the company itself. If the investor is shorting the stock, their interests will be diametrically opposed to those of the company and its other stakeholders, including long-term shareholders, as they will stand to gain if the company’s share price falls.

In this scenario, it is far from clear why it is shareholders whose interests companies should be required to promote, nor why it is shareholders who should have the ultimate say over how companies are run. In addition to our proposals to reform directors’ duties set out above, the TUC believes that voting and engagement rights should be subject to a minimum period of share ownership, which we suggest should be two years.

The TUC is also concerned that a narrow interpretation of trustees’ fiduciary duty to their beneficiaries has discouraged pension funds and their advisors and fund managers from taking a long-term view of their investments. Ever since the Scargill vs Cowan case in 1984, there has been a widely held view that fiduciary duty requires trustees to maximise fund returns, often interpreted as short-term returns, at the expense of all other considerations. This has discouraged trustees, fund managers and advisors from pursuing strategies that seek to take into account of environmental, social and governance (ESG) issues, despite clear evidence of the positive impact that taking ESG issues into account can have on fund performance11. It can also be seen in fund managers’ responses to mergers and takeovers, as demonstrated by the Kraft takeover of Cadbury, where fund managers clearly believed that it was their duty to sell their shares once a high enough price had been offered, regardless of the long-term impact on Cadbury. For a more detailed discussion of conceptions of fiduciary duty within the investment chain, see the Fair Pensions Report Protecting Our Best Interests12.

The fact that both asset managers and other intermediaries such as advisors generally see themselves as responsible to their immediate clients such as pension funds rather than the ultimate beneficiaries of these funds is also relevant to this issue.

The TUC believes that clarification from the Government or the Pensions Regulator of fiduciary duty and in particular how it relates to long-term investment and ESG issues and the responsibilities it confers on the different actors in the investment chain would be extremely beneficial, and would urge the Review to support this.

A further concern stems from interpretations of the fiduciary requirement of ‘prudence’, which is generally interpreted as requiring fiduciaries to invest as would other ‘prudent’ investors. This may encourage the tendency towards herding discussed above and discourage fiduciaries from adopting strategies that follow a different approach from the rest of the market.

11 See, for example, Demystifying Responsible Investment Performance, A joint report by The Asset Management Working Group of the United Nations Environment Programme Finance Initiative and Mercer, October 2007

12 Available at www.fairpensions.org.uk/fiduciaryduty
We would particularly welcome evidence on:

a. whether there is a more rapid turnover of asset managers and whether this makes it more difficult for these managers to take a long term view of the companies in which they invest;

The TUC is not aware of evidence that would show whether the length of time that asset owners engage a particular fund manager has decreased over time. However, we are aware of numerous instances where pension funds have changed fund manager on the basis of the latter’s performance. While it is clearly essential that pension funds and other asset owners should be able to change their fund manager if they believe that this is in the interests of their beneficiaries, it may also be the case that fear of underperforming the market discourages fund managers from bucking the trend and encourages a herding approach to investment, rather than one based solely on the propensity of companies to create value over the long-term.

b. how individual asset managers are rewarded, and their performance measured, and whether this gives insufficient incentive for them to take a long term view of the companies in which they invest;

Many individual fund managers are employed on short-term contracts, with both their remuneration and the extension of their contracts dependent on performance, often measured over the short-term. This incentive structure does not encourage them to take a long-term view of company performance.

c. whether there are agency problems in the objectives and operations of asset managers that may be deleterious to the interests of the corporate sector or savers;

Many of the points made throughout this submission point to the existence of agency problems within the operations of asset managers. In particular, there is pressure for short-term relative fund performance which can act against the interests of beneficiaries in long-term absolute fund performance. Fund manager contracts (see b above) can also contribute to agency problems.

7. Whether there is sufficient transparency in the activities of fund managers, clients and their advisors, and companies themselves, and in the relationships between them.

We would particularly welcome evidence on:

a. whether the existing rules on disclosure of material stakes are excessive or inadequate;

The TUC believe that for effective investor stewardship of companies, it is important that both companies and investors are able easily to ascertain who actually owns company shares. Currently, this is not straightforward. We believe that this should be addressed.
b. whether asset managers should be subject to more extensive disclosure requirements, e.g. of costs and remuneration structures;

The TUC believes that there should be much more transparency in relation to costs, charges and remuneration structures of fund managers. Disclosure of information on remuneration structures, including incentive targets and timescales, would help to expose the conflicts of interest that can be created by some fund manager contracts.

We would strongly support measures to make information on charges much clearer and more prominent so that it is easier for pension funds and asset owners to make meaningful comparisons between the charges of different fund managers. This is a very important issue because charges that sound small can have a major impact on ultimate returns to savers. An RSA report calculated that a 1.5% annual management charge will lead to a cost of around 40% over the life of the pension. This is also a critical issue for personal pensions, which generally have much higher charges than collective schemes.

The TUC is particularly concerned about the increase in share turnover in recent years and the costs that this has placed on pension funds. It is also of concern that this increase has come about largely without being explicitly recognised by fund managers and their clients or the latter’s advisors. Dr Paul Woolley has argued that pension funds are having their assets exchanged and traded on average 25 times over their lifetime, even though in the long-term this drains pension funds of 30% of their value. He attributes this behaviour to agency problems between fund managers and their clients. We would support mandatory reporting by fund managers to clients on the costs of share turnover so that clients can see directly how much it is costing them. We would support a requirement for fund managers to report publicly on the issue of share turnover, so that potential clients can take this into account in their manager selection process, and exploration of ways to cap share turnover.

In addition to costs, charges and remuneration information, the TUC would support full disclosure of fund managers’ voting records. This is explored in more detail under c.

c. whether the growth of investment consultants has encouraged or discouraged engagement by share owners with companies;

We cannot say what the impact of the growth of investment consultants has been; however, we are of the clear view that investment consultants have notably failed to encourage engagement between share owners and companies. In our work with pension fund trustees, we know of no instances where consultants have raised the issue of engagement with trustees.

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13 David Pitt Watson, 2009, Pensions for the people: addressing the investment crisis in Britain (RSA)

14 The Future of Finance: the LSE Report, Paul Woolley, Sept 2010
We believe that this is partly because investment consultants have largely failed to recognize the long-term benefits to investors of effective engagement and have therefore failed to identify this as something that they should promote to their clients.

As set out above, the TUC believes that the Stewardship Code should be revised to clarify the responsibilities of all the different participants in the investment chain in relation to stewardship, including asset owners and consultants.

d. whether the overall costs of intermediation are understood by beneficiaries, and are proportionate to the value of the services provided;

Our experience suggests that many beneficiaries and those responsible for making decisions on their behalf do not realize the impact that intermediation is having on the costs to their scheme.

This is particularly problematic given the significant increase in intermediation that has taken place in recent years. The number of mandates for externally managed pension funds has increased significantly in recent years 

Part of the reason for this is almost certainly the emphasis on diversification promoted by both public policy and the industry. As set out above, pension fund are required by law to hold diversified portfolios. Paul Myners’ report on Institutional Investment in the UK encouraged pension funds and other institutional investors to increase their exposure to alternative assets, and in recent years there has been advice from the fund management industry that in order to reduce risk pension funds should reduce their exposure to equities and to UK equities in particular. As a result, UK pension funds have significantly reduced their exposure to UK equities over recent years. While this may have achieved other important benefits, it has also contributed to an increase in intermediation and has implications for the ability of investors to engage effectively across their entire asset portfolio.

e. whether investors have sufficient information to understand the investment approaches of asset managers and to judge whether they are aligned with their investment objectives and timescales.

The TUC believes that there is insufficient public information about the approach and record of asset managers for clients and potential clients to make an informed judgement about the different approaches that are on offer. This is particularly true in relation to voting and engagement and issues relevant to stewardship.

We have noted an improvement in the voting disclosure of respondents to our annual Fund Manager Voting Survey over recent years. In the most recent Survey, 13 respondents indicated that they disclose a full voting record, compared to nine last year. However, there are still significant problems with the quality of
disclosure from some fund managers, with some still disclosing only no votes and abstentions, while others disclose only headline statistics on voting. And while disclosure has improved among our Survey respondents, the statements on the FRC Stewardship Code website indicate that the majority of asset managers still do not publicly disclose voting data (many of these are smaller asset managers, but they still own an important slice of the UK stock market).

The key finding of the TUC Fund Manager Voting Survey is that there are significant variations in the approach taken to voting at AGMs by different fund managers, with some significantly more likely than others to vote against management on a range of issues from executive remuneration to shareholder resolutions. It is therefore of great importance that comprehensive, comparable voting data is made available to enable clients and potential clients to compare the differing approaches of different fund managers.

We would support mandatory public disclosure of fund managers’ voting records, and the development of a standardised format for disclosure to promote comparative analysis. The standardised format needs to include information on all votes cast, not just no votes and abstains, and for data to be left on websites indefinitely, to facilitate longitudinal analysis. Despite the laggards, there are now some excellent examples of voting disclosure, with some fund managers providing comprehensive, searchable information, which provide a very good basis for the development of a standardised format.

There is much less public disclosure of engagement activities. The TUC Fund Manager Voting Survey 2011 found that the large majority of respondents indicated that they report back to clients (or scheme members in the case of pension funds) on engagement activity undertaken. A much smaller number reported that they disclose engagement information publicly. The TUC would support mandatory public disclosure of engagement activity, including outcomes, as we believe that this would help clients and potential clients to compare the approaches of different fund managers on engagement, and that in addition there is a wider public interest in the quality of engagement that takes place between fund managers and companies.

8. The quality of engagement between institutional investors and fund managers and UK quoted companies, and the importance attached to such engagement, building on the success of the Stewardship Code.

We would particularly welcome evidence on:

a. whether the measures taken to stimulate engagement by investors with companies have been sufficiently effective;

The TUC has serious concerns about the quality of engagement that takes place between fund managers and companies. Institutional investors hold highly diversified portfolios; the IMA says that the average fund manager holds 450 shareholdings, and for some it will be in the thousands. The TUC’s Fund Manager Voting Survey asks each year about how many people fund managers have
working on corporate governance and responsibility issues. With five exceptions -
two teams of 30 or more, two teams of twenty or more and one with twelve
people – all other respondents have less than ten staff working on these issues.
However skilled and dedicated such staff may be, it cannot be possible for them to
engage effectively with all the companies whose shares they hold over all the issues
for which shareholders are ultimately responsible.

While we support the introduction of the Stewardship Code as an important step
in the right direction, we do not believe it is sufficient to make the UK’s
shareholder-oriented corporate governance system operate effectively.

The impact of the Stewardship Code on the quality of investor engagement seems
to be relatively limited to date. The TUC’s 2011 Fund Manager Voting Survey
asked respondents what, if any, changes they had made changes to their voting and
engagement practices as a result of the introduction of the Stewardship Code.
Several respondents said that they had made no changes in response to the Code,
with some saying they believed they already met its requirements. However, a
number of respondents did identify changes made as a result of its introduction:
several mentioned that they had improved engagement recordkeeping, and in
addition, changes to internal policies (including stock-lending and conflicts of
interest policies), reporting to clients and public reporting were all mentioned.
Notably, only one respondent stated it had increased the resources devoted to
stewardship and only one said that communication with companies had changed
as a result of the Stewardship Code.

It is also important to be clear that the quality of engagement can be very variable
and engagement per se is not necessarily conducive to the pursuit of long-term
company value. A good example here is that, before the financial crisis, investors
put pressure on Lloyds and HSBC to increase their use of leverage and other
strategies that had been followed by other banks. It is fortunate for those investors
and for the whole economy that Lloyds and HSBC largely resisted this pressure.

b. whether the corporate governance activities of asset
management businesses are sufficiently integrated with the
decisions of fund managers.

Anecdotally, we know of frustrations among corporate governance and SRI staff
within fund manager organisations that their views can be trumped by those of
portfolio managers.

The TUC Fund Manager Voting Survey 2011 asked respondents who made the
final decision on votes (i.e., portfolio manager, corporate governance manager etc).
Of the 18 respondents giving a clear answer to this question, eight stated that the
final decision was taken by the corporate governance or responsible investment
team, or an individual within it. Six stated that the decision was usually the
responsibility of the portfolio manager. A further three suggested that there was a
collective process involving both portfolio managers and governance staff,
particularly in respect of active holdings or where there were controversial issues at
hand. One respondent said responsibility for the decision was dependent on the
issue, with portfolio managers responsible for decisions on acquisitions, disposals
and so on, and the governance manager playing a larger role on other issues. This suggests that responsibility for voting issues is split pretty evenly between corporate governance and portfolio managers. Given that only three suggested that there was a collective process, it does not suggest a high degree of collaboration between the two groups, although this may more be a reflection of the specific question that was asked. It also does not throw light on the extent to which corporate governance and SRI teams have an impact on buy/sell decisions.

9. The impact of greater fragmentation and internationalisation of UK share ownership, and other developments in global equity markets, on the quality of engagement between shareholders and quoted companies.

We would particularly welcome evidence on:

a. what has been the effect of the internationalisation of UK equity markets on the priorities of companies and fund managers;

b. whether the growth in overseas ownership of UK equities, and in the overseas activities of UK listed companies, has affected engagement between UK investment institutions and UK companies.

Share ownership patterns have changed rapidly over recent decades. In the 1960s, the majority of shares in UK companies were owned by individuals, many of whom took a reasonable level of interest in the companies whose shares they owned. By the 1980s, the majority of shares were owned by UK institutional investors such as pension funds and insurance companies. Today, this has changed again, and recent figures from the Investment Managers’ Association (IMA) suggest that pension funds and insurance companies now hold around 13% of UK equities each, with an additional 14% held by other UK institutional investors\(^\text{16}\). ONS figures show that at the end of 2008, 41.5 per cent of UK-listed shares were owned by investors from outside the UK, and individuals held just over ten per cent, the lowest percentage since the survey started in 1963\(^\text{17}\).

These changes have great significance for the quality of engagement between fund managers and companies. It will clearly be harder for overseas investors to develop the kind of engaged relationships with UK companies that are envisaged by the UK’s corporate governance system. Language, culture, proximity and availability of information all make engagement much more straightforward within a national context in comparison with engaging with companies abroad. This is reflected in responses to the TUC’s Fund Manager Voting Survey: in the 2011 Survey, 21 respondents said they voted all their UK shares, while just ten voted all their overseas shares, although a further seven indicated that they voted the large majority, or a large proportion of their overseas holdings. The UK’s corporate

\(^{16}\) IMA, Asset Management in the UK 2009 – 2010, July 2010

\(^{17}\) Available at http://www.statistics.gov.uk/cci/nugget.asp?id=107
governance system was not designed on the basis that the largest single share ownership block would be investors from outside the UK.

The IMA has made it clear that its members are wary of too weighty expectations being placed on their governance role: ‘The fact that UK investors now own a smaller proportion of UK companies has implications for the corporate engagement role that investment managers play in the governance of companies. There is concern amongst investment managers that there should not be unrealistic expectations of what they can achieve through engagement.’

The increasing role of investors whose strategies are based on short-term share trading such as hedge funds is also relevant here, as the interests of these investors may not coincide with the long-term interest of the company whose shares they hold. While the proportion of shares owned by alternative investment managers across the stock market as a whole remains fairly low, the ability of alternative investment managers to buy and sell large numbers of shares in a particular company over a short period of time magnifies their influence in the market. This issue is discussed in more detail in answer to question 6 above.