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18 October 2007

To: **MEMBERS OF THE PENSIONS COMMITTEE**

Dear Members

PENSIONS COMMITTEE - THURSDAY 25 OCTOBER 2007

I attach a copy of the report for the above-mentioned meeting which was not available at the time of collation of the agenda and marked "TO FOLLOW":

ITEM REPORT

4. REVIEW OF RESPONSIBLE INVESTMENT POLICY, A REPORT BY HYMANS ROBERTSON: (PAGES 1 - 66)

To consider a review of the Council's Responsible Investment Policy.

Yours Faithfully

NICOLAS MATTIS
Principal Committee Coordinator

Enc.

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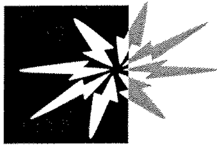
Agenda Item 4



Haringey Council

Agenda item:

Pensions Committee **On 25 October 2007**

Report Title: **Review of Responsible Investment Policy**
Forward Plan reference number: Not applicable
Report of: Acting Director of Finance
Wards(s) affected: **All** / Report for: **Non-Key Decision**

1. Purpose

1.1 This report considers a review of our responsible investment policy.

2. Introduction by Cabinet Member

2.1 Not applicable.

3. Recommendations

3.1 That our responsible investment policy in practical terms apply to UK and non-UK equities and to pooled funds; not bonds.

3.2 That we revise our responsible investment policy after analysing our fund managers current policies and this be reported back to Pensions Committee for approval.

3.3 That we adopt the United Nations Principles for Responsible Investment and encourage our fund managers to also adopt these principles.

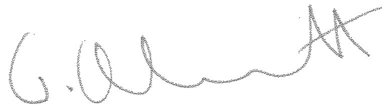
3.4 That our existing manager led approach to voting and engagement be continued on an improved basis to include reporting regularly to Pensions Committee to explain and justify where they do not follow our policy and voting guidelines once agreed.

3.5 That we do not engage in stock screening or exclusionary approaches.

3.6 That we consider joining LAPFF.

3.7 That we encourage our fund managers to sign up to the Enhanced Analytics Initiative.

3.8 That the possibility of the fund investing in funds that target environmental issues be reviewed.



Report Authorised by: Gerald Almeroth – Acting Director of Finance

Contact Officer:

John Hardy, Head of Finance-Budgeting, Projects & Treasury (tel no: 020 8489 3726)

4. Acting Director of Finance comments

4.1 The financial implications section of the report sets out the financial position.

5. Head of Legal Services Comments

5.1 The Head of Legal Services has been consulted on the content of this report. In considering its content and its recommendations Members should have regard to their duties in relation to the fund and its investment. The essential elements of the fiduciary duty of the Members of the Pension Committee are the following:-

a) to act prudently and in good faith;

b) to act in the best interests of the beneficiaries of and contributors to the pension scheme as a whole; and

c) to seek to maximise the assets of the pension scheme.

5.2 Pensions Committee members operate under the provisions of the statutory duty on the Authority to formulate an investment policy, which, amongst other matters, considers the suitability of particular investments and types of investment. The formulation of this policy must involve the obtaining of proper advice from its professional advisors.

5.3 It is strongly arguable that a reasonable investment policy should consider the long term as well as the short term interests of the stakeholders. While for example

particular forms of investment might generate short term gains to the fund, if those forms constituted irresponsible investment, this might well harm the longer term interests of the fund and its beneficiaries and could be validly taken into account. However, the key issue is that any consideration of these possible conflicting aspects must be carried out by reference to relevant considerations, such as the interests of the beneficiaries and contributors.

5.4 Guidelines published by CIPFA for the consideration of shareholder responsibilities in the management and investment of funds deal both with the issues of shareholder responsibility for promoting and supporting high standards of corporate governance and with the approach that it is proper to take when considering a policy of socially responsible investment. This guidance is appended to the report from Hymans Robertson at Appendix 6 and should be given careful consideration.

5.5 Provided that members keep their fiduciary duties outlined above in mind, many of the recommendations set out in this covering report are within the powers of the Committee to determine without further legal advice. Thus recommendations 3.1, 3.3, 3.4, 3.6 and 3.7 would fall within this framework. Other areas, which require a greater analysis of the effect on rate of return on investments and the nature of any additional costs and risks, will require further legal advice, (as advised by Hymans Robertson at Section 9 of their report), on the relationship between the fiduciary duties of Members and the impact of a wider socially responsible investment policy. Such advice would be best obtained from specialist Counsel. This would apply in relation to any final decisions made, after review, in relation to recommendations 3.2 and 3.8. once the relevant reports are brought back to the Pensions Committee. Recommendation 3.5 is within the power of the Committee to make in the form set out in the covering report. However if Members were minded to engage in stock screening or other exclusionary approaches, further legal advice would be required before any final decision is made on this issue.

6. Local Government (Access to Information) Act 1985

6.1 Previous reports to Pensions Panel in 2000/01 when our current policy was approved.

7. Strategic Implications

7.1 The proposed changes to our responsible investment policy are made with a view to improving our policy to reflect latest thinking on this matter and having due regard to our fiduciary duty. We are proposing to improve our Responsible Investment policy by widening our policy to apply to UK and non-UK equities and to pooled funds; not bonds and implement a number of other measures as set out.

7.2 One of the Council's priorities is to make Haringey one of London's greenest Boroughs. Whilst investment policy should not be seen as a key contributor to this objective as the aim of investment policy is clearly to maximise returns, it is appropriate for investment decisions to consider environmental issues.

8. Financial Implications

8.1 The Acting Director of Finance advises that the proposals made to develop our responsible investment policy are a good way forward to reflect latest thinking on this matter. We are also seeking to avoid any legal issues regarding our fiduciary duty. Therefore any reports to future meetings of this Committee will be shared with the Head of Legal Services for full advice. The proposals take account of our preference for a low maintenance solution to minimise in-house administrative costs. Other measures would add additional burden of administration and costs.

8.2 The annual cost of becoming a member of LAPFF will be charged to the Pension Fund if approved.

9. Equalities Implications

9.1 None.

10. Consultation

10.1 Not applicable.

11. Background

11.1 Our current Responsible Investment policy is included in Appendix One and was introduced approximately 6 years ago and therefore it is an appropriate time to review this.

11.2 Hymans Robertson have prepared a report, included as Appendix Two, that has been updated following a meeting with the Acting Director of Finance and Howard Jones, Independent Advisor to trustees.

11.3 The aim is to ensure that we consider latest thinking on this subject so that any changes proposed represent good practice, fully take account of CIPFA guidelines and advice from the Head of Legal Services to avoid any legal issues regarding our fiduciary duty.

11.4 The report from Hymans Robertson considers our current policy, takes account of CIPFA guidelines, and how options for developing our current policy links in with our fiduciary duty.

11.5 The attached report also considers the scope of our policy and concludes that our policy should be widened from only UK equities to include both UK and overseas equities and also equities held in pooled funds but not to include bonds.

11.6 It is proposed to revise our responsible investment policy after analysing our fund managers current policies and this be reported back to Pensions Committee for approval. This revised policy would need to be included in our Statement of Investment Principles (SIP).

11.7 The report proposes adopting the United Nations Principles for Responsible Investment and also encouraging our fund managers to adopt these principles.

11.8 Options regarding voting and engagement are discussed. It is proposed to continue with our existing manger led approach to voting and engagement but on an improved basis to include regularly reporting to Pensions Committee to explain and justify where they do not follow our policy and voting guidelines once agreed.

11.9 The issue of stock screening and possible exclusion of specific shares is considered but discounted due to potential loss and therefore the possibility of challenge from stakeholders.

11.10 Overlay strategies are also considered and discounted due to the potential to be challenged over fees incurred.

11.11 Consideration is given to joining LAPFF and this is deemed to have some benefit.

11.12 It is considered a good idea to encourage our fund managers to sign up to the Enhanced Analytics Initiative.

11.13 It would be possible to consider investing a relatively small allocation of funds to funds that target environmental issues and propose that this be reviewed.

11.14 The proposals take account of our preference for a low maintenance solution to minimise in-house administrative costs.

12 Use of Appendices - reports by Hymans Robertson

Appendix 1 – Our existing SRI policy

Appendix 2 - Responsible Investment report from Hymans Robertson.

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Policy Approach to SRI

Haringey's Socially Responsible Investment policy relates to issues of the Environment, Sustainability, Human Rights and Employee Care and the impact of such issues on the Fund's UK Equity portfolios. These issues are of concern to the Pension Fund because it is considered that Companies who

- do not have regard for the environmental impact of their business, or
- who conduct their business in a way which is not sustainable over the longer term or
- who engage in, or condone the abuse of Human Rights or
- who fail to adequately care for the wellbeing of their employees

are in danger of adversely affecting the future prospects of the company, and potentially the company's share price.

The Fund has decided to use its influence, via its investment managers, to improve corporate behaviour where it finds examples of shortcomings in the approach of companies to these issues. The overall approach is to establish a range of issues, using EIRIS within each of the categories of Environment, Sustainability, Human Rights and Employee Care which are felt to be diagnostic of the company's overall performance in that area, and to ascribe a numeric score to their relative performance on each issue.

Scores may be weighted to reflect the relative importance of the chosen issues. These scores can then be summed at the Company level and a ranking order produced. A process of "engagement" is then expected to be pursued, focussing on those stocks, where appropriate, with the lowest score.

Some of the shortcomings of this approach should be noted, however. The answer produced is dependent on many variables and judgements within the scoring matrix. The inclusion of an issue within the matrix may be limited or hampered by the amount and quality of the research data available. The results therefore do not represent an absolute statement on the merits or worth of a company or its activities. Instead the scores and ranking orders provide a **priority order or trigger** for more specific research and information gathering by the investment manager. The issues raised by the analysis also help to form an agenda for discussion with the companies.

The Fund has a policy of not excluding companies on the grounds of their activities per se. Whilst financial considerations remain paramount, the scoring system could also help managers to make choices between companies on environmental or sustainability grounds where the financial analysis gives no clear signal as to the company's future potential. This will become increasingly important as SRI becomes adopted as a mainstream investment activity.

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Hymans Robertson
INVESTMENTS AND BENEFITS

LONDON BOROUGH OF HARINGEY PENSION FUND

SOCIALLY RESPONSIBLE INVESTMENT

OCTOBER 2007

Geoff Singleton - Senior Investment Consultant
William Marshall - Investment Analyst
Dr. Craig McKenzie – SRI and Governance Advisor
For and on behalf of Hymans Robertson LLP

PUBLIC SECTOR

HYMANS ROBERTSON LLP

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Please note the value of investments, and income from them, may fall as well as rise. This includes equities, government or corporate bonds, and property, whether held directly or in a pooled or collective investment vehicle. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets.
Exchange rates may also affect the value of an overseas investment. As a result, an investor may not get back the amount originally invested. Past performance is not necessarily a guide to future performance.

October 2007.

1 EXECUTIVE SUMMARY

This report focuses primarily on the way in which the London Borough of Haringey Pension Fund ("the Fund") discharges its responsibilities, as an equity owner, via its investment managers. The report covers on a number of socially responsible strategies that the Fund might consider. Some of these strategies are relatively straightforward to implement (e.g. application of the UN Principles for Responsible Investment Section 8) while others (e.g. investment in Special Funds – Section 7) would require further work and consideration.

In order to give the Committee an overview of the report, we summarise the main recommendations in this section. However, this summary is no substitute for reading the detailed arguments that support the recommendations. It also seems to us that, when considering the development of the Fund's Socially Responsible and Green agenda, it would be useful to prioritise the initiatives and tackle them sequentially, rather than trying to move forward on several fronts at once, so overburdening the governance and supervisory systems of the Fund.

We have recommended that the Fund concentrates its Socially Responsible Investment (SRI) activities on its segregated equity holdings (Section 3 and Appendix 4) in the first instance. With regard to the holdings in Pooled Funds (Section 3 and Appendix 5) we recommend that the Fund questions the managers of its Pooled Funds as to the standards of voting, governance and engagement that they employ in managing those funds and the extent to which Environmental, Social and Governance (ESG) issues are included in the investment decision making process.

We strongly recommend that the Fund does not engage in stock screening or exclusionary approaches (Section 3) and that if such an approach is contemplated then Counsel's opinion is sought as to the Council's powers in this respect. Instead, we recommend that the Fund's ownership responsibilities are discharged through voting and engagement (Section 3).

We recognise that implementation of a satisfactory Voting and Engagement approach is, in practice, difficult to implement and we examine three alternatives (Section 4). Our recommendation, which we accept may need to be improved further in the long term, is for the Fund to adapt existing voting procedures. This recommended approach involves assessing the segregated managers' existing voting policies for consistency and acceptability to the Fund. If a manager's policies prove satisfactory, they would continue to exercise votes on behalf of the Fund and report back on any exceptional circumstances, where they did not vote in accordance with those policies.

We do recognise that existing managers' activities, with regard to Engagement, fall short of the standard that the Fund might wish of them (Section 4 and Appendices 1 and 2). We suggest the Committee encourages the managers to improve their efforts in this regard and also to consider whether membership of the Local Authorities Pension Fund Forum (LAPFF) (Section 5) might go some way towards redressing the shortfall on engagement activity.

We draw attention at Section 6 to the Enhanced Analytics Initiative and recommend that the Committee encourages its managers to sign up to the initiative.

In Section 7 we briefly draw attention to the possibility of the Fund investing in funds that target environmental issues such as climate change, carbon trading, clean technologies etc. This would require a decision of the Fund regarding strategic asset allocation and, particularly in the public markets, would require further research into the opportunity set available. It would be easier to make such investments in the private equity markets where the opportunities are fewer and the Fund already has an allocation to private equity.

We recommend at Section 8 that the Fund either adopts the United Nations Principles for Responsible Investment or encourages its managers so to do, or both. If the Fund were to adopt these Principles, it would be one of the first UK pension funds to do so and, we believe, the first London Borough to do so.

In Section 9 we remind the Committee that they have a fiduciary duty to the stakeholders of the Pension Fund and a duty to treat each equally. The Committee needs to be aware that some of the initiatives surrounding Socially Responsible Investment enter onto unproven ground and that, as a body governed by statute, the Fund must be clear of its powers. Throughout this report we have tried to draw attention to issues where we think the issue of powers is particularly relevant but, we should make it clear that we are unable to give legal advice.

SUMMARY OF RECOMMENDATIONS

A summary of the recommendations made in this paper are as follows:

- The Fund's responsible investment policy applies to its segregated and pooled (where possible) equity holdings;
- The Fund does not implement an exclusion policy. Instead we recommend that its ownership responsibilities are discharged through voting and engagement;
- The Fund's existing voting policy should be adapted. The updated approach would involve assessing the managers' existing policies and, if they are deemed consistent and acceptable, they should be adopted by the Fund;
- A manager-led approach should be used to exercise the updated voting policy. If any of the managers vote against the Fund's policy, they would report this to the Committee;
- The Committee should give consideration to joining the Local Authority Pension Fund Forum. The Committee should also encourage the Fund's managers to sign up to the Enhanced Analytics Initiative;
- Consideration should be given to investing in specialist SRI funds. However, any potential investment would require further analysis to be carried out;
- The Committee should adopt the UN Principles of Responsible Investment. It should also encourage the Fund's managers to do so.

We look forward to discussing the report with the Committee.

2 BACKGROUND

INTRODUCTION

The London Borough of Haringey [the Council] is the administering authority for the London Borough of Haringey Pension Fund [the Fund] which is a statutory fund established under the provisions of the Superannuation Act 1972 and governed by Regulations issued and amended from time to time by the Department for Communities and Local Government. The Council has established an Investment Committee [the Committee] to oversee the affairs of the Fund.

ADDRESSEE

This report is addressed to the Council as the administering authority of the Fund. It should not be released or otherwise disclosed to any third party except with our prior written consent, in which case it should be released in its entirety. We accept no liability to any other party unless we have especially accepted such liability in writing.

CURRENT POSITION

The Fund has been at the forefront of developments in the arena of socially responsible investment and, since 2001, has had a Socially Responsible Investment (SRI) policy in respect of stocks held by the Investment Managers. In brief, this policy required the Fund's Investment managers to adopt a system of ranking stocks held in their portfolios by reference to a series of Environmental, Sustainability, Human Rights and Employee Care measures as a means of providing a priority order, or trigger, for more specific research and information gathering by the investment manager. It was intended that this would help to form the basis of an agenda for discussion between investment managers and the companies concerned, in terms of improving the approach of those companies towards the specific policy screens.

It has never been the aim of the scoring matrix to identify low scoring companies in order to require investment managers to sell those stocks. That decision remains, explicitly, with the investment manager. Rather, the scoring matrix is a device to generate discussion about the reasons why those stocks are held and to try to improve the overall approach of companies through investment manager led engagement.

The approach to Voting is integral to the policy and managers are instructed to vote wherever possible on the basis of their own internal voting guidelines. Managers are expected to report on a regular basis to the Committee.

DEVELOPMENTS IN SRI

One of the difficulties about being at the forefront of developments is that the pioneering work is not always as effective as approaches that come later and which are developed with the benefit of greater experience. Socially Responsible Investment in the UK has not developed as quickly or as far as was anticipated in 2000/2001.

Partly this slower pace of development was because the agenda of pension fund trustees and quasi – trustees became diverted by other, more pressing, issues. The bursting of the TMT stock market bubble, the higher cost of pension schemes due to falling bond yields, the increase in pension fund deficits occasioned by the recognition of improved mortality are all examples of factors which have occupied Trustees' minds. These, and other factors, resulted in large pension fund deficits arising which gave rise to higher pension fund costs, both to recover deficits and to pay for ongoing benefit accrual, which in turn led to more fundamental appraisal of the advantages from an employer's perspective of defined benefit schemes.

Meantime, within the socially responsible marketplace, several existing influential managers continued to invest with their SRI approach and to develop their thinking, while other organisations became attracted to the longer term possibilities of SRI. As a result, during the intervening period when pension funds were busy with other fundamental issues, the SRI industry began to offer new approaches and other data providers became established, creating options that were unavailable when the Fund developed its original policy.

3 SOCIALLY RESPONSIBLE INVESTMENT: THE SCOPE

The scope for Socially Responsible Investment activity with regard to the Pension Fund is largely concerned with what action could or should be taken in respect of the Fund's segregated equity holdings in the UK and Overseas. It is true that the concept of socially responsible investing would also embrace such matters as internal governance of the Pension Fund, its communications strategy with its stakeholders and stakeholder accountability but it is considered that these issues are outwith the intended scope of this project.

In the case of the Haringey Fund the segregated equity holdings are summarised below and listed in more detail in Appendix 4.

Segregated Holdings of Common Stock	No of Holdings	Value GBP 000	% of Fund
United Kingdom	89	163,879	27
Overseas Stocks	338	126,673	20
Total	**427**	**290,552**	**47**

CORPORATE BONDS

The Fund does invest in debt instruments issued by Companies (Corporate Bonds) and, to the extent that it does so, has some opportunity to respond to and influence company behaviour. However, this opportunity is of a lesser order than that conferred by holding equity and the moral responsibility to take action is comparably lower. In addition much of the Fund's holding in Corporate Bonds is, or will shortly be, held in pooled funds (even current segregated holdings are small – c £1m for six lines of stock). For these reasons we propose to ignore the possibility of actions in respect of corporate bonds in this report.

POOLED FUNDS

Some of the Fund's Equity and Corporate Bond exposure is achieved via investments in pooled funds. A list of those pooled funds is attached at Appendix 5 where it will be seen that £205m (which represents one third of the Fund) is so invested.

Where the Fund gains its exposure to Equities and Corporate Bonds through pooled funds it has no direct ownership rights in the underlying investments and no direct ownership responsibilities in the case of equities. It cannot therefore act, or be expected to act, with regard to those holdings.

However, from a Fund governance perspective, the Fund may wish to question the managers of those pooled funds as to the standards of voting, governance and engagement activity they employ in managing those pooled funds and the extent to which they take Environmental, Social and Governance [ESG] risk factors into their investment decision making. If the Fund does take up this suggestion then it is something that the Fund may wish to repeat on an annual basis.

SCREENING AND EXCLUSION

For some investors one approach to socially responsible investing involves avoiding investing in companies that are involved in certain types of activity, for example the manufacture and sales of arms, or tobacco, or alcohol etc. This is a suitable approach for the retail investment sector where investors are acting for themselves, in their own interests, and have no responsibilities to third parties. It may also be appropriate in respect of some charitable funds where it would be incongruous to invest in products which contribute directly to the problem that the charity has been established to ameliorate, for example, Cancer charities and tobacco companies.

Agencies do exist which provide screening services that enable investors to identify the extent of companies' involvement in a wide range of activities that are thought to be of possible concern to investors of different types.

Studies into the performance of funds which employ screening and exclusionary approaches generally demonstrate that, over the long term, returns relative to suitable market benchmarks are not harmed by such approaches provided that the exclusions are not "all-embracing" and that the investment manager is left with sufficient choice and flexibility to exercise normal professional skills.

However, it is generally considered that ethically-motivated exclusionary approaches are not a suitable method through which Pension Funds should seek to discharge their responsibilities, and it may well be ultra vires for local government pension funds to adopt them. In addition, exclusion means that the investor also forgoes ownership rights and therefore loses much of the opportunity to influence company behaviour. More importantly, however, is the juxtaposition of motive and fiduciary responsibility.

It is a precept of common law that those who hold funds for the benefit of others must act in the interests of those beneficiaries and where there is more than one beneficiary or groups of beneficiaries must act equally towards each and not disadvantage one relative to the other. This is the essence of what is commonly termed the fiduciary responsibility of Trustees.

Elected Members of Local Government bodies (Councillors) are not acting as Trustees when they take decisions relating to the Pension Fund, since the pension fund has no separate legal identity and is simply another fund of the Borough Council. However, Councillors do hold a fiduciary responsibility to all the stakeholders of the Borough Council in discharging their responsibility, in respect of any monies in their charge. In the case of the Fund it is possible to identify the stakeholders as the contributors, pensioners (active and deferred) and the local taxpayer who underwrites the liabilities. The only interest that this group of stakeholders has in common is that of securing the best return for the Fund, consistent with taking an acceptable level of risk, and bearing in mind the requirement to maintain contribution rights as stable as possible. This in itself is a complex matter, which Councillors will be all too aware of, and it leaves little scope for other considerations, particularly where it cannot be shown that those considerations are commonly held by the stakeholders and would not give rise to conflicts of interest between them.

Although we have stated above that most studies, over the long term, and relative to appropriate market indices, tend to show that exclusionary policies do not harm returns. However, the fact is that some stocks, which might tend to be excluded under such conditions, can outperform markets for significant periods of time, such that returns might have been improved had those stocks been available to the investment manager to include in the portfolio. Councillors operating an exclusionary policy run the risk of challenge from any stakeholder or interested party which, if upheld, might result in personal loss.

We do not advocate the adoption of exclusionary policies, but should the Committee be minded to consider such an approach, we would recommend, in the strongest possible terms, that sound professional legal advice be obtained as to the extent of the Council's powers in this matter.

VOTING AND ENGAGEMENT

In our view, the most suitable, and possibly the most socially responsible, approach for a Pension Fund is to act in the way that a responsible owner of a company would act if he had appointed a manager to run his business and had delegated day to day control over the affairs of his business. That person would give his view when matters, which were thought to be of key importance, were brought to his attention (i.e. he would exercise his **vote**) and, if he had concerns about aspects of his business's activity, he would seek to influence the manager to whom he had delegated the day to day affairs to modify that behaviour (i.e. he would **engage** with management).

Clearly, in the case of large public companies, ownership is shared with many other shareholders and the voting and engagement activity of one shareholder is necessarily much less influential than that of the owner of a private company who has delegated day to day running of the company. However, it is the scale which is different not the principle of responsible ownership.

In the next Section we discuss the practical ways in which the Fund, as a shareholder and part owner of many companies throughout the world, might seek to discharge the responsibilities of ownership.

CIPFA GUIDANCE

The Chartered Institute of Public Finance and Accountancy (CIPFA) issued a Guidance Note (Pensions Guidance Notes No 2 – May 1999) to its members in 1999 relating to the investment of funds governed by the LGPS in respect of shareholder responsibilities regarding corporate governance and ethical investment criteria. The Guidance Note has not been revised and is still in force. It provides a useful background to the Committee's consideration of these issues and we have attached a copy in Appendix 6.

4 VOTING AND ENGAGEMENT

As shareholders, pension funds, collectively, have significant formal and informal powers to influence the direction of the companies in which they invest. The most tangible of these powers is voting at AGMs on issues including the appointment of directors and how their remuneration is structured. In practice, the informal powers to meet and 'engage' with chairmen, directors and other managers, and to raise concerns about governance and corporate responsibility issues, are equally important as means to influence corporate behaviour. Indeed, on environmental and social issues, informal engagement is a much more effective mechanism, given the very limited opportunities to vote on these subjects.

There are three main models of voting and engagement which might be considered. These are described briefly below.

FUND LED APPROACHES

This would normally mean that a Pension Fund would establish its own, detailed, voting policy and exercise those votes directly in accordance with that policy. It may involve direct contact with investee companies where there is conflict with the Fund's voting policy on specific issues. Service providers are available who can help Funds formulate their own policies, give guidance on voting issues and execute instructions. A variation on the theme would be to instruct investment managers to vote in accordance with a Fund specific policy.

It would be quite possible for a Fund like Haringey to go down this route and, in our view, remain within its powers. The problem with this approach is that it is a high maintenance approach for the Fund. A common problem that Pension Funds in the UK (not just LGPS Funds) generally experience is a lack of Officer resource, particularly at the peak voting time between April and July, and high turnover of trustees and quasi – trustees. Thus, it is easy for a detailed "hands on" approach, established in good faith under one set of circumstances, to be overtaken by events and to become neglected. Furthermore, exercising voting power to effectively influence corporate behaviour typically requires shareholders to enter into frequent dialogue with company directors, which is time consuming and requires specialist knowledge. This implies significant costs for the Fund, which are hard to justify on direct investment performance grounds, raising potential fiduciary issues for the Fund (see below).

MANAGER LED APPROACHES

The Fund's existing approach is an example of a manager led approach. Generally speaking, managers are instructed to vote and engage with investee companies in accordance with policies and standards that they have previously established. The results of their activities are reported to their clients and dialogue with well informed groups of trustees can ensure that the investment manager's approach continuously improves through the process of challenge by those clients. Managers may have internal resources available to them or they may utilise the services of external agencies to replace or supplement internal resources. This is probably the most common approach applied in the UK at the present time.

The main issue with this approach is the variability of its quality, i.e. different managers accord corporate governance and SRI differing levels of importance and devote varying degrees of resources to it (from nearly zero to dedicated teams with several staff). Some of the most active managers are able to demonstrate dozens of examples where their shareholder activism prompted improvements to corporate governance and corporate responsibility practice. The inactive managers (who are in the majority) tend to record no success of this kind. In fact some (including Alliance Bernstein and Capital International) are explicit that they do not even see influencing directors as their role. This means that if a pension fund happens to have relatively inactive managers, it will not be able to deploy its voting and engagement power effectively. As yet, manager capability

in this field is not a key criterion in their appointment to investment mandates and it is not clear to what extent it should become so. Moreover, it is often the case that managers whose SRI credentials are particularly strong have less good investment credentials and they do not often make the short lists for manager appointments. So, typically, most pension funds that adopt this approach end up with SRI outcomes that fall far short of what is possible to achieve. We recently conducted a survey among the leading investment managers operating in the UK Pension Fund industry and will shortly publish our findings. An early draft of the, as yet, unpublished survey is attached at Appendix 1. The survey demonstrates compellingly the weakness in the current approach by most investment managers.

Among the respondents to the survey were the Fund's three equity managers Alliance Bernstein, Capital International and Fidelity (pooled funds approach). We have also, in preparation of this report, taken the opportunity to have a discussion with Alliance Bernstein and Capital International about their approach to activism. Our comments on each of these managers are given below.

ALLIANCE BERNSTEIN

This manager made clear that it sees its role as achieving the best possible financial returns for its clients. It sees this as a challenging task and is, therefore, committed to focusing its resources whole-heartedly on achieving it, without the distraction of seeking to influence companies to improve their behaviour. It does not have specialist staff devoted to shareholder activism. Alliance Bernstein makes a plausible case that, because of the nature of its investment process, it does have a superior understanding of the financial risks associated with governance and SRI issues. Furthermore, when these issues are material, it does take them into account in investment decisions. However, it does not generally seek to influence companies on these issues, even when they are material. For example, when it discovered that BP's approach to managing health and safety issues was flawed, it reduced its stake in the company, but it did not attempt to use its influence to encourage the company to do better in the future. The manager does, however, vote client shares according to an established voting policy.

CAPITAL INTERNATIONAL

Capital similarly focuses on financial performance and does not, as a matter of course, seek to influence companies on governance and SRI issues. It does have one staff member devoted to (primarily) governance issues, who does meet with companies specifically on these topics. But there is no systematic programme of shareholder activism devoted to seeking improvements to corporate governance and corporate social responsibility. As with Alliance Bernstein, Capital feels that, as a matter of principle, it should only take account of governance and SRI issues when there is a material (highly significant) financial case for doing so. It made clear that it does not see its role as 'campaigning' to improve social performance for its own sake and has said that its primary focus, when engaging with companies, is to improve its understanding of how issues are being managed, rather than to effect change. It uses Institutional Shareholder Services (ISS) to vote its shares according to a well-defined policy.

FIDELITY

Fidelity's focus in looking at governance and SRI issues is primarily on their implications for investment decision-making. It does not have a large scale programme of engagement with companies to encourage change on these issues. It does have dedicated analysts focused on aspects of environmental and governance risk (e.g. on carbon markets) and a dedicated SRI analyst who does meet with companies to discuss these issues. Fidelity seems to have a more relaxed position about engaging with companies on non-financially-material issues than Alliance Bernstein or Capital, but it does not deploy significantly greater resources to the task.

From the above, we conclude that the Fund can be content that its votes are being exercised by its managers, and that the most financially significant aspects of governance and SRI issues are considered in their investment processes (perhaps with a high degree of competence). However, we can also conclude that its influence as an active share owner is not being deployed effectively to encourage high standards of corporate governance and corporate responsibility.

OVERLAY STRATEGIES

This approach sits above the Fund and manager-led approaches and effectively unbundles voting, governance and SRI issues from investment management and out-sources these issues for the entire, consolidated, stock holdings to a third party that will report back to the Fund.

There are only three organisations providing this service in the UK and they devote much larger and more focussed expertise to the subject than mainstream investment managers. These managers tend to raise concerns about dozens of SRI and governance issues with hundreds of companies each year, and are typically able to document considerable efficacy in delivering outcomes. One focuses exclusively on conventional corporate governance issues; another mostly on these issues, with some attention given to wider SRI issues; and the third takes a balanced 50:50 approach. We asked each organisation to provide a brief summary of their services and a broad indication of cost. We have included these submissions in Appendix 3.

However, as with each of the other approaches, there are some drawbacks with the Overlay Strategy.

Compared to a Fund-driven approach, the fund to some extent loses control over the voting policy and the agenda of issues for detailed engagement. This is because these service providers are servicing a number of clients and even their resource is finite so that some priority setting is inevitable. However, overlay providers do claim to offer clients opportunities to comment upon and influence the overall voting policy and engagement agenda (in fact they remark that their clients are not as demanding as they expected in this respect).

The legislative intervention of the Government to amend the Pensions Act 1995 to require pension funds to state in their Statements of Investment Principles [SIPs], the extent (if at all) to which fiduciaries take account of social, ethical and environmental issues and to state their voting policy, along with the absence of any rebuttal to the assertions regarding voting and activism in various Myners Reports, suggests that the principle that owners are expected to take an active ownership/governance role in the companies in which they invest has been established in the UK. What has not been established is the lengths or limits to which pension funds as owners might go, or should go, in fulfilling that responsibility.

One view might be that, by appointing investment managers to select and manage stocks, funds have delegated their responsibilities and the fee that they pay reflects, among other things, a reasonable level of voting, governance, and where necessary, engagement activity. To the extent that managers perform less well in this role (and our Survey gives a clear indication of substantial variability, at least, in this regard) then, as a starting point, it should be for the Trustees to press those managers for better performance in this area of their contract by setting standards for managers to achieve, and by demanding accountability against those standards. However, if that fails then presumably a fund would be justified in pursuing alternatives.

There is also a possible cost objection. By separating voting, governance and engagement from the manager led activity of stock selection and portfolio management the pension fund will have to pay an additional fee. This has to be justified and is not straightforward. It is difficult to show that there is direct investment return from this activity and some of the benefits (if such exist) may be accessed via “free rider ship”. On the other hand it does seem reasonable to suggest that in the long-run it is in the interests of pension fund beneficiaries that companies are well-governed and behave in a socially responsible manner. It also seems likely that if enough shareholders are prepared to be activist, they are able to encourage improvements to corporate governance and corporate responsibility performance. This may provide justification enough for pension funds to incur modest costs (a few basis points at most) to support this activity.

Of course, this is fairly untested ground and we cannot exclude the possibility, though probably unlikely, that such expenditures may be considered ultra vires for LGPS funds. We would recommend that the Fund would need to satisfy itself that it had the powers to incur the necessary expenditure in those circumstances, particularly given that it has the ability to free-ride on the shareholder activism of others in the market place. We note that some comfort may be taken from the fact that the costs of overlay services are relatively small for large funds; and that the government has, via the Myners Report and other initiatives, established a clear expectation that pension funds should play a role as active owners in companies.

Hymans Robertson is currently running a research project to evaluate objectively the approach of each of the three organisations listed in Appendix 3, with a view to being able to recommend which of them is most likely to be able to provide the service that most closely meets the requirements of LGPS funds. Part of that project will include a scheme whereby LGPS Funds that decide to take up this approach can secure a substantial discount from the fee levels quoted in Appendix 3. This project is “work in progress” and the signs that a significant discount can be achieved appear favourable. For that reason it would be premature for the Fund to open negotiations with one or more of these bodies until this work is complete (expected before the end of 2007), although of course a “decision in principle” could be taken.

WHICH APPROACH TO ADOPT?

We do not believe that a fund led approach on its own is likely to be viable or effective for Haringey. There is a choice, subject to the Fund clarifying its powers, between improving the present set of arrangements with existing managers (which may not succeed, particularly with regard to engagement activity) and appointing an overlay service provider.

However, we would suggest that in the first instance a compromise approach should be attempted, with regard to voting, which draws on both a fund led approach and the manager led approach. This would involve reviewing each investment manager’s voting policy to establish how consistent they are and how acceptable to the Fund they might be. In the event that the managers’ policies proved to be broadly acceptable to the Fund, the Fund would adopt them as Fund Policy. Managers would be asked to vote in line with those policies and, on an exceptions basis, report to the Committee in respect of those circumstances where they did not vote in line with the policy. These situations could then be discussed by the Committee when the manager next appears before them.

5 LOCAL AUTHORITY PENSION FUND FORUM

The Local Authority Pension Fund Forum [LAPFF] was established in 1990 to promote the investment interests of local authority pension funds and to maximise their influence as shareholders, whilst promoting corporate social responsibility and higher standards of corporate governance amongst the companies in which they invest.

The Forum meets quarterly and provides an opportunity for discussion and debate on a broad range of investment issues concerned with shareholder responsibilities. However, membership of the Forum does not impede a fund's ability to act unilaterally where it is considered to be in its best interests.

Meeting Agendas are constructed by members of the Forum, which has an Executive Committee comprised of elected member representatives of Forum members, a (Honorary) Secretary and Treasurer and its own part-time Forum Officer – Keith Bray, a former County Treasurer. Meetings are serviced by PIRC Ltd, an independent research and advisory consultancy that provides services to institutional investors on corporate governance and corporate social responsibility.

The Forum has over 40 LGPS members (see table) whose pension fund assets total about £70 billion.

LGPS Fund Type	Number of Funds
County Councils	15
London Boroughs	12
Former Metropolitan County Funds	7
Passenger Transport Authority Funds	2
Scottish Funds	2
Welsh Funds	4
Northern Irish Funds	1

The Forum does undertake some limited engagement activity on governance and SRI issues; however, the level of activity is significantly lower than that provided by the overlay providers described above. We suggest that it probably will not serve as a substitute for them. However, the Fund should give consideration as to whether joining LAPFF would assist it in discharging its socially responsible investment responsibilities and the best way to do that would be to arrange for a presentation from LAPFF at a future meeting. We understand the fee to join LAPFF would be relatively modest.

6 ENHANCED ANALYTICS INITIATIVE

In addition to engagement and voting, the other main SRI strategy to gain favour with pension funds in recent years is so called 'integration', or sometimes also known as 'enhanced analysis'. With this approach asset managers adjust their financial analysis and portfolio construction approaches to better integrate Environmental, Social and Governance (ESG) risk factors into their investment decision-making.

The rationale for this approach is provided by evidence which shows that the capital markets may not be very efficient at taking account of ESG information. If so, there may well be opportunities for managers to deliver alpha via better ESG analysis. Furthermore, if financial markets are mis-pricing ESG risk, then they may be sending damaging signals to companies: companies with high ESG risks may end up with higher share-prices than they deserve, and companies that manage their ESG risks may end up getting penalised.

By helping address any mis-pricing, the 'integration' approach may therefore deliver value for pension funds while also serving some social or environmental benefit. Haringey's existing managers are all committed to taking account of ESG risks in investment decision-making, and because of the size and quality of their in house financial analysis teams, they probably have a stronger claim than most to do so fairly effectively (at least for risks that will materialise over the short to medium terms). Although Haringey's managers say that they allocate a percentage of stock broking commissions to firms that do analysis of ESG issues, they do not disclose the amount or proportion of that commission.

None of the Fund's equity managers are members of the Enhanced Analytics Initiative; an initiative that was set up by leading pension funds to encourage investment managers to allocate a proportion of their dealing commissions to brokers who focus on ESG issues.

Haringey could ask its managers to sign up to the Enhanced Analytics Initiative. This could be done without the Fund incurring any costs.

7 SPECIAL FUNDS INVESTING

There are some additional routes by which Haringey could move forward on its SRI approach.

There are investment managers that run specialist funds that focus on aspects of environmental investing and/or the new technologies associated with it.

PRIVATE EQUITY

In the Private Equity space there are two managers (and as far as we know there are only two in the world) who run funds that focus on "Clean Technologies". i.e.

- Energy
  - Generation, storage, transmission, distribution and utilisation
  - Renewable energy sources
- Clean Air and Water
  - New technologies for desalination and filtering water
  - Clean air scrubbers and new catalytic converters gaining traction
- Advance Materials
  - Applications for solar photo-voltaics, fuel cells, advance batteries and LEDs

The Fund could consider a modest allocation from its existing private equity programme and it would be relatively easy to arrange presentations from these managers.

PUBLIC EQUITY

Public Equity markets are more diverse and somewhat more complex in the range of approaches available.

For example, there are managers like Generation Investment Management, whose focus is to attempt to form a view of how industries will evolve over time and what emerging issues such as climate change, carbon controls, emphasis on human rights etc will generate for them. Having done that, they will seek to establish which companies are currently well run, profitable and are best placed to meet those challenges and continue to evolve positively. Other funds include the Merrill Lynch New Energy (Investment Trust) and RCM's Global Ecotrends Fund. There are also various INNOVEST sub-advised products and several climate change indices, some of which are the basis of investable products.

More detailed research into this area would be required to support any recommendations, but in principle a strategic allocation could be made to this type of investment theme. The Fund could carry out a more detailed evaluation of existing managers and available funds on this issue, or to search for potential specialist managers and/or service providers.

It needs to be borne in mind; however, that each of these initiatives would create additional relationships to be managed, monitored and supervised and it possibly involves the Committee making an investment judgement (which it is perfectly entitled to do) at a more detailed sector level than it has done in the past.

8 UNITED NATIONS PRINCIPLES FOR RESPONSIBLE INVESTMENT

In April 2006 the United Nations launched its "Principles for Responsible Investment" ("PRI"). These principles call for pension funds to give due attention to Environmental Social and Governance ("ESG") issues in their investment decision making and to be responsible owners. While the principles are voluntary, they do require pension funds to report their activity each year – and there is a detailed questionnaire which they must complete. The principles have been endorsed by many of the worlds largest pension plans (in the UK these include BT Pension Scheme, Environment Agency {Active Fund}, Universities Superannuation Scheme, BBC Pension Fund) as well as over 80 asset managers and a number of service providers, including Hymans Robertson. The PRI also provides an information resource on emerging best practice in responsible investment and a clearing house for engagement activity undertaken by its signatories.

The Principles (from the UN website) are:

1 WE WILL INCORPORATE ESG ISSUES INTO INVESTMENT ANALYSIS AND DECISION-MAKING PROCESSES.

2 WE WILL BE ACTIVE OWNERS AND INCORPORATE ESG ISSUES INTO OUR OWNERSHIP POLICIES AND PRACTICES.

3 WE WILL SEEK APPROPRIATE DISCLOSURE ON ESG ISSUES BY THE ENTITIES IN WHICH WE INVEST.

4 WE WILL PROMOTE ACCEPTANCE AND IMPLEMENTATION OF THE PRINCIPLES WITHIN THE INVESTMENT INDUSTRY.

5 WE WILL WORK TOGETHER TO ENHANCE OUR EFFECTIVENESS IN IMPLEMENTING THE PRINCIPLES.

6 WE WILL EACH REPORT ON OUR ACTIVITIES AND PROGRESS TOWARDS IMPLEMENTING THE PRINCIPLES.

None of the Fund's managers have adopted the UN Principles for Responsible Investment. One of the ways in which Haringey can act, and be seen to be acting, is

- Either adopt the principles itself

    and/or

- Encourage its manager's so to do.

In order to adopt these Principles, the Fund would have to write a letter to the UN. We understand there would be no explicit joining fee, but the Fund maybe asked to make a donation to the UN ($10,000 is typically a suggested donation).

9 FIDUCIARY DUTY

In this area of pension fund investment activity, more than any other, the issue of potential conflict between a desire to use the Fund's influence to achieve certain outcomes and the fiduciary duty of elected local authority members to the Fund's beneficiaries and financiers comes into play.

Hymans Robertson is not a law firm and is not qualified to give legal advice. However, we would recommend that, prior to any radical departure from the Fund's existing voting policy, which we believe is a commonplace policy and within the Fund's powers, the Fund seeks some formal guidance, possibly in the form of Counsel's Opinion, on what it is entitled to do and what the limits, if any, of its fiduciary duty are. This might be particularly beneficial in the light of the recent development of new SRI strategies, which have found support from several of the world's largest pension funds under the aegis of the UN Principles for Responsible Investment.

We look forward to discussing this report with the Committee.

APPENDIX 1 SURVEY OF ASSET MANAGER ACTIVITY ON ENVIRONMENTAL, SOCIAL AND GOVERNANCE ISSUES (2007) (DRAFT)

SUMMARY

This survey is divided into the following sections.

INTRODUCTION

There are a number of drivers for increasing pension fund interest in ESG issues. This is reflected in widespread support for the new UN Principles for Responsible Investment and the two core ESG strategies embedded in these principles: active ownership and integration of ESG into investment analysis.

ACTIVE OWNERSHIP - VOTING

The most basic form of active ownership involves voting shares in companies. All asset managers covered by this survey do so. However, there are considerable differences in the resources, diligence and efficacy of managers voting behaviour, as well as the extent to which managers are prepared to challenge company management.

ACTIVE OWNERSHIP - ENGAGEMENT

A number of asset managers do not simply vote their shares, but also seek to meet with company management to discuss concerns about ESG issues. A few asset managers have substantial resources devoted to this task, holding more than 100 meetings each year, and demonstrating significant ability to influence corporate decisions. On the other hand the majority of managers undertake virtually no activity of this kind.

PUBLIC POLICY ADVOCACY

Many asset managers participate in efforts to influence policy makers in order to safeguard shareholder rights, and to encourage a regulatory environment conducive to good governance and responsible management of corporate environmental and social impacts. However, a small number of managers do an order of magnitude more work in this area than others.

ESG INTEGRATION

Most managers accept that ESG issues can be financially material, and take them into account in their investment decision-making. However, few managers devote special attention to these issues and only a handful employ substantial dedicated resources. As a result relatively few mangers can point to examples where their enhanced analysis of ESG issues has added value from an investment point of view. However, a growing number of managers are allocating broker commission to this area.

INTRODUCTION

This is the first survey that Hymans Robertson has published on asset managers' activity on environmental, social and governance (ESG) issues. It responds to a significant growth in interest in this topic in recent years. This growth in interest in ESG is in part a response to the growing appreciation of the financial significance of these issues for pension funds. The financial irregularities at Enron, Worldcom, Tyco and Parmalat in the early part of the decade convinced many that governance is a financially material issue that deserves attention. Similarly, climate change, bribery and corruption scandals, and controversies over human rights and labour standards have put environmental and social issues firmly on the investment agenda.

At the same time there has been steady (if rather low key) pressure from the UK government to encourage pension funds to give more attention to ESG issues. In 2000, a change was made to the 1995 Pensions Act, requiring pension funds to state, in their Statement of Investment Principles, the extent (if at all) to which social, ethical and environmental issues are taken account in investment; and to state their voting policy. This has led to the insertion of a great deal of boiler-plate in SIPs, but it has also encouraged a minority of pension funds to develop active programmes to address these issues. In addition, the government-backed Myners Principles[1] called for pension funds to take a more active role in governance, with the threat of regulatory intervention if voluntary action not forthcoming.

Other stakeholders have also played their part. Some scheme sponsors, particularly in the public sector, have exerted some pressure for the pension scheme to take a more active approach to ESG; and a modest level of demand has been demonstrated by relatively small numbers of scheme beneficiaries.

A further development is that a minority of asset managers have started to offer ESG products and services that are more compatible with the constraints of fiduciary duty, than traditional 'screening' based approaches typically adopted by retail ethical investment funds. Some of these will be described below.

These developments have to varying extents been replicated internationally, with the result that there is growing interest in ESG among pension funds, globally. This interest was crystallised in the launch, in April 2006, of the UN Principles for Responsible Investment[2]. These principles, call for pension funds to give due attention to ESG issues in their investment decision making and

UN Principles for Responsible Investment

1.**We will incorporate environmental, social and governance (ESG) issues into investment analysis and decision making processes.**

2.**We will be active owners and incorporate ESG issues into our ownership policies and practices.**

3.**We will seek appropriate disclosure on ESG issues by the entities in which we invest.**

4.**We will promote acceptance and implementation of the Principles within the investment industry.**

5.**We will work together to enhance our effectiveness in implementing the Principles**

[1] **http://www.hm-treasury.gov.uk/media/4/3/myners_principles_web.pdf**

[2] **www.unpri.org**

to be responsible owners. While the Principles are voluntary, they do require pension funds to report their activity each year - and there is a detailed questionnaire that they must complete. They have been endorsed by many of the worlds largest pension funds (see box), as well as over 80 asset managers and a number of service providers, including Hymans Robertson. This means that ESG issues are now becoming firmly established as a mainstream part of investment management for pension funds and, as a result, it is timely to see what managers are doing. The survey will loosely follow the UN PRI in dividing approaches to ESG issues in focusing on active ownership (Principle 2) and integrating ESG issues into investment decision-making (Principle 1), though our survey also looks at public policy advocacy, another emerging area of ESG activity, not yet covered in the PRI.

Some of the better known signatories of the UN PRI

BT Pension Scheme	UK
Environment Agency Active	UK
Pension Protection Fund	UK
USS	UK
BBC	UK
Caisse des dépôts et consignations (CDC)	France
Fonds de réserve pour les retraites (FRR)	France
National Pensions Reserve Fund of Ireland	Ireland
ABP	Netherlands
PGGM	Netherlands
Norwegian Government Pension Fund	Norway
AP1, AP2, AP3	Sweden
CalPERS	USA

SURVEY METHODS

This survey is based on a questionnaire, sent in May 2007 to the 50 largest asset managers ranked by UK pension funds assets under management. 30 managers completed the questionnaire (see back cover for a list). Several of these provided incomplete answers to several questions. The participants were quite diverse, including: both UK domiciled and US and Europe-based managers; generalist managers offering multiple asset classes as well as equity boutiques; both managers with strong reputations for ESG and those with no reputation in this area.

The survey questions covered: overall ESG policy; resources devoted to ESG issues; voting activity; company engagement on ESG issues; enhanced analysis; public policy activity on ESG; and memberships.

ACTIVE OWNERSHIP

Pension funds depend on the sustainable commercial success of the companies in which they invest. This success depends to a large degree on the quality of leadership and governance at the top of companies, which in turn requires shareholders to play an active and informed part in the process. Investors should have every interest in playing this role given that their money is at stake, or so it might seem.

Some investors take their interests and responsibilities as active owners very seriously: employing specialist staff; monitoring corporate governance and corporate responsibility practice in their key holdings; voting their shares with careful consideration; meeting companies regularly to discuss concerns and to ask for changes. Such investors can typically point to a number of examples where this intervention has led to significant changes in companies, many of which are value enhancing. Indeed some investors have created specialist funds (e.g. the Hermes Focus funds) which claim to deliver alpha as a result of this activity.

But other investors prefer not to undertake this activity. When they encounter poor governance they would sooner sell their shares than seek improvements. Whatever the economic merits of such an attitude, it is hard to

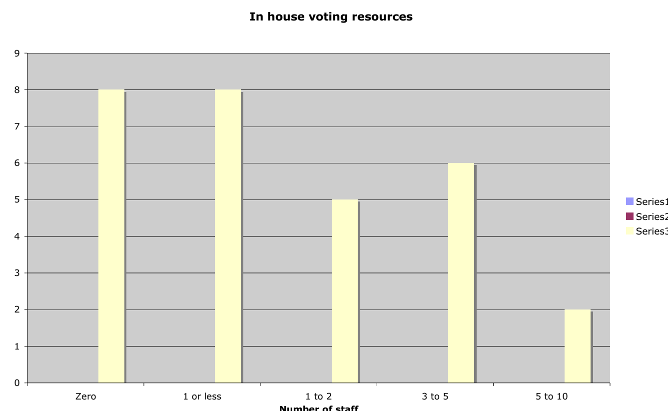
square it with any reasonable conception of responsible investment. On this view, shareholders are owners of companies whether they like it or not, and as such they cannot escape some moral responsibility for what is done in their name by the company's concerned. They have a duty to hold directors accountable for ensuring at least a minimum level of governance and corporate responsibility.

Frustratingly for those who hold this view, various reports[3] have found that few pension funds and asset managers seem prepared to fully exercise the active ownership role. This conclusion appears to be supported by this survey.

VOTING

A chief executive of a major listed company would, perhaps, be forgiven for thinking that his largest institutional shareholders give careful consideration to how they vote their shares in his company. Based on this survey, he would for the most part be wrong.

One of the most striking features of the results of the survey is the extremely limited amount of activism practised by the majority of asset managers. None of the managers who responded can be criticised for not voting. On the contrary, all the managers who responded vote most or all of the shares they hold. In fact, on average they voted on 20,000 resolutions at 2000 company meetings around the world. Where criticism is perhaps appropriate is the fact that most of them do this without any devoting any significant internal resources to the task. As the chart below indicates, 28% have no in house resource devoted to this task and a further 28% have less than 1 person – to cover 20,000 resolutions!



Of course, the fact that they have little or no internal resources does not imply that votes are cast without any thought at all. Most asset managers make use on computer driven voting services, where votes are cast according to automated templates. Such services have many virtues, but they do remove practical decision-making about voting from investors to outside agencies, which hardly helps encourage constructive debate between companies and their investors. The people in asset management houses who make decisions about buying and selling shares never speak to the people who shape the computer systems voting decisions.

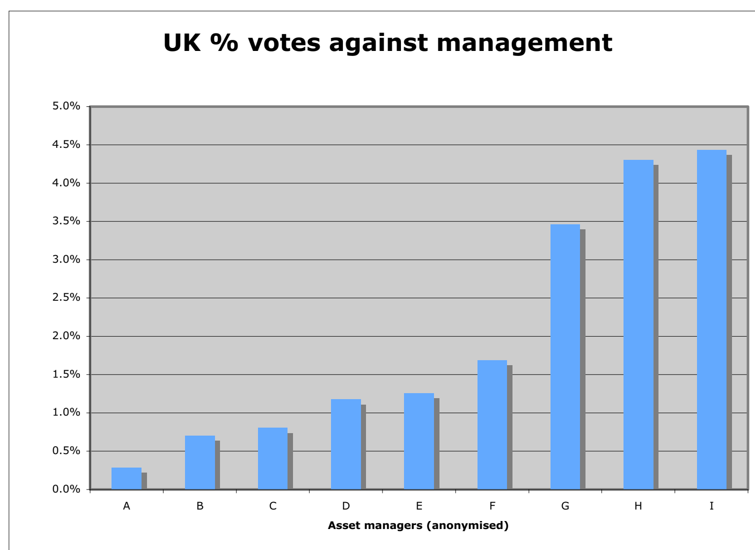
This lack of discussion in the voting process extends to the relationship between investors and the companies they own. Many managers in our survey rarely if ever discuss their voting decisions with companies, even when they choose to vote against management. Six managers (out of 18 who responded to this question) admitted to not having discussed *any* of their UK voting decisions with companies.

[3] **For example, the report on the Myners Principles implementation prepared by the Department for Work and Pensions (www.dwp.gov.uk/asd/asd5/ rports2003-2004/rport213/Inside.pdf)**

At the positive end of the scale, a minority of managers are much more active. 6 have three or more staff focused on voting activity and 2 have more than 5. These managers are in regular discussion with company management about their voting activity, contacting dozens or even hundreds of companies each year to inform them of the reasons for their voting activity. This, presumably, is the kind of activity that the government's Myners review had in mind, when it encouraged companies to fulfil their responsibilities as active owners.

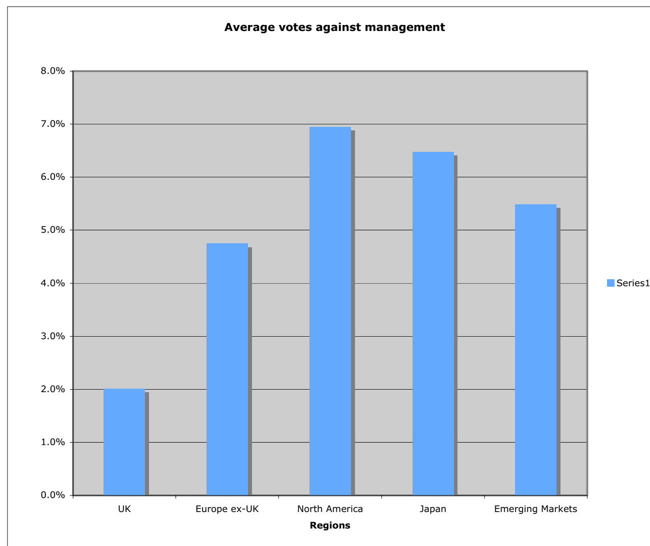
VOTING PATTERNS

So far we have covered levels of voting activity, but what about the voting stance of managers? Are some managers more or less likely to challenge management by voting against management resolutions? Making comparisons here is not straightforward, given that each asset managers will hold shares in different portfolio of companies. However, it is possible to look at the proportion of a manager’s votes that are for or against resolutions.



As the UK voting table shows, there is a considerable amount of divergence in the willingness of managers to vote against companies. Some managers are several times more likely to vote against company resolutions than others. The picture is even more extreme in some other markets. In Japan, for example, one manager votes against management 1% of the time while another does so 10% of the time.

As the chart on regional voting averages shows, there are some markets in which investors are rather more likely to vote against management than others. This most likely reflects differences in the severity of governance problems in these markets, together with ease of gathering information and exercising votes. It seems likely that emerging markets have the greatest governance problems, but this is counterbalanced by the difficulty of voting in these markets.



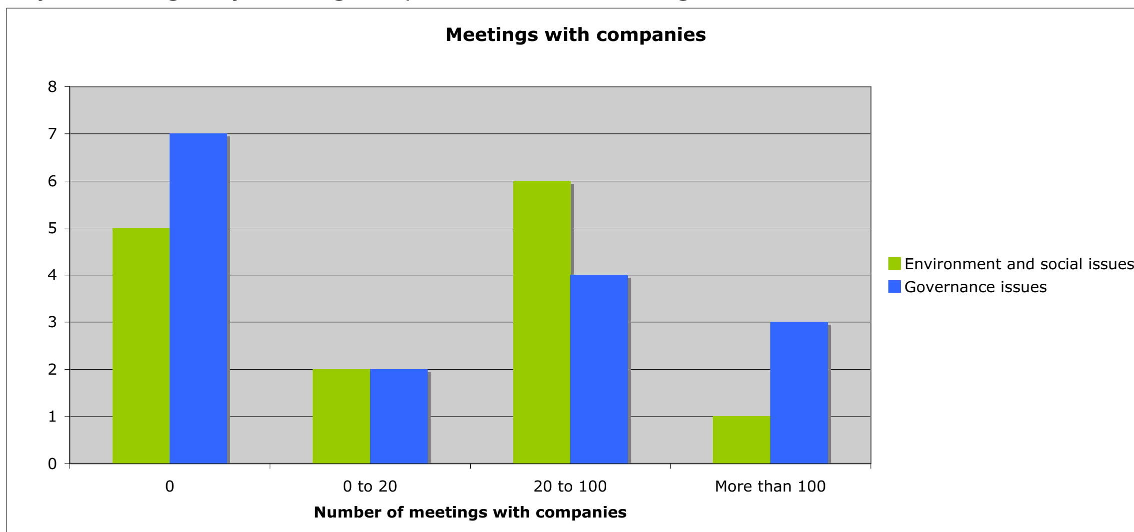
In discussing voting patterns it is very important to point out that only 10 managers out of the original 50 provided sufficiently detailed voting data across all markets. There may well be substantial selection bias in this sample. In other words, managers with the most respectable voting record could be more likely to provide data. If so, one can see why shareholder activists get so frustrated about the lack of willingness of many investors to exercise their voting rights in support of enhanced governance.

ENGAGEMENT

Voting shares at the annual general meeting is not the only opportunity shareholders have to voice their opinions about the governance of companies. Some shareholders seek to engage with companies to discuss ESG issues on a regular basis and recommend changes to corporate behaviour. On environmental and social issues, such meetings are more or less the only route for managers to raise concerns with companies; because (except in the USA) such issues are rarely the subject of formal voting opportunities.

As the table shows, there is again a considerable diversity of activity by managers. Roughly half of the managers that responded indicated that they rarely or never have these kinds of meetings with companies. One manager stated explicitly that "we are not engaged in influencing corporate decisions." Further, it is likely that the managers who responded to the survey are among those most likely to be the more active, so the total percentage of non-active managers is probably rather greater. On the other hand, a handful of managers are

very active, regularly meeting companies to discuss both governance and environmental and social issues.



Many of the managers who do engage in this kind of behind the scenes engagement activity, claim that it is an effective means for investor to encourage improvements in corporate governance and the management of environmental and social risks. Most managers who claim this can point to several examples where their engagement has delivered changes to corporate behaviour. Indeed two managers claim more than 100 changes following their engagement activity. Such claims need to be treated with caution, given the difficulties of proving cause and effect. Nevertheless, there is evidence that some managers may be effective at persuading corporate executives to change their behaviour.

It is worth emphasising that, among those managers that engage with companies on ESG issues, three display a level of activity and effectiveness that is an order of magnitude greater than the rest. 10 managers reported regularly making requests for companies to change their behaviour; of which 8 make 20-30 requests per year, but the remaining two make no fewer than 1650 requests between them. (There is a third manager that credibly claims a similar degree of activity, but will not disclose numbers). Even more impressively, the two managers who disclose their data point to a total of 660 cases where they recorded companies making changes following their engagement activity. In both cases, this level of work is supported by a large team of specialist engagement professionals.

Another point worth making about manager engagement activity is the poor record-keeping that appears to be demonstrated by some managers, who admitted not keeping records of the numbers of meetings they had with companies or of the requests they made for changes. This is perhaps a weakness worth addressing, given rising levels of client interest.

It is important to offer one caveat on this topic. Some active equity managers said that while they do not have dedicated resources for ESG, and while they do not specifically ask for meetings on these topics, their mainstream analysts and portfolio managers do have a very large number of meetings with company finance directors and chief executives each year, and they do, from time to time, raise ESG issues in these meetings. What are we to make of this? It is certainly true that these meetings take place, and that they can influence corporate behaviour. However, these meetings often have very full agendas – they are, after all one of the primary opportunities for investors to discuss key financial issues with the company executive, so it unlikely that that ESG issues are raised very often, or that they are given sufficient time to receive adequate treatment. It is

also the case that many ESG issues are best discuss with the company chairman, the chair of the board remuneration committee, or corporate officers specialising in ESG, rather than the chief executive. It would be wrong to conclude from this that it is in anyway inappropriate to raise ESG issues in these meetings, far from it – doing so sends important signals to management. The more appropriate conclusion might be that such meetings should be a supplementary channel of communication on ESG, not the *only* one.

ASSET MANAGER GOALS

The survey sought to elicit the underlying goals asset mangers have in addressing ESG issues via engagement activity. Roughly half managers responding to the survey see their activity in this area as exclusively in pursuit of the financial interests of their clients. The other half take a wider view: they will pursue corporate environmental, social and governance improvements for their own sake as long as the do not *conflict with* their clients' financial interest. This is an important distinction. There are a great many ESG issues where companies have some level of business-case justification for taking positive action – for example, BP reduced its carbon emissions by 10%. Doing so saved it a significant amount of money (more than enough to justify the costs). But for a company the size of BP, the benefit was trivial. An asset manager of the first kind, solely interested in financial goals, would have no reason to engage with BP to encourage this activity. On the other hand, asset managers who are prepared to pursue environmental goals, as long as they don't harm their customers interest would have been quite prepared to do so.

This broad picture seems to be confirmed by other findings of the survey – the managers that state a commitment to achieving both financial and ESG goals are mostly the ones that deliver impressive ESG outcomes. This raises an important question for pension funds when agreeing the terms of their investment management agreements. If they wish their managers to pursue ESG goals they should make clear that they wish them to act in the large number of cases where doing so does not conflict with their financial interests, and not just in the rather small number of cases where there is an overwhelming financial case for immediate action.

PUBLIC POLICY ADVOCACY

There are several reasons why it might make sense for investors to engage with governments to address the ESG performance of the companies in which they invest. Many aspects of corporate governance are influenced by regulatory requirements (e.g. Sarbanes-Oxley, the Combined Code). The ability of shareholders to be activist depends on legally backed shareholder rights of various kinds - including the right to disclosure by companies and to vote on certain important issues. Lobbying governments to improve regulatory aspects of corporate governance and to strengthen shareholder rights can therefore be an effective way of serving the long-term interests of investors while also achieving public interest goals.

As far as environmental and social issues are concerned, many of the harmful impacts of corporate activities arise because of market failures of various kinds. For example, climate change is happening because companies (and consumers) are emitting carbon dioxide into the atmosphere without taking account of the enormous costs these emissions will impose future generations. Getting companies to take account of these 'external' costs is necessary to stop climate change, but doing so requires government action. As a result of this a minority of shareholders have started to play a role in the public policy process supporting government action on important ESG issues. One group of investors, the Institutional Investors Group on Climate Change recently issued a public statement encouraging policy makers to introduce more ambitious, long-term climate change regulation to provide companies with the certainty necessary to invest in making the transition to a low carbon economy.

The survey found that most fund managers 20 out of 27 had engaged in some public policy advocacy. 14 of which had done so by participating in formal government public policy consultation and 7 of which by

approaching government ministers directly. Some managers only claim to be active in the UK, while a few others are active in multiple jurisdictions (i.e. UK government, EU Commissions, US Securities and Exchange Commission).

Public policy advocacy, however, seems to only to be allocated a small proportion of resources. 10 managers allocate no staff time to this activity. 16 allocate one member of staff or less; and only two allocate substantial staffing 3.75 and 5 respectively. The two who do so, tend to focus mostly on seeking to influence government policy in various jurisdictions on corporate governance and shareholder rights rather than social and environmental issues.

INTEGRATION OF ESG INTO INVESTMENT DECISION-MAKING

In addition to its focus on active ownership, the UN PRI also commits investors to integrating ESG issues into their investment analysis and decision-making. There are two reasons why this is considered important. Firstly, ESG risks and opportunities sometimes have a financially material impact on companies. When this is so, investors have a straightforward fiduciary responsibility to consider taking them into account, in order to maximise returns for beneficiaries. For example, if poor corporate governance is likely to harm shareholder returns, then investors have a *prima facie* reason to take this into account in their analysis. Of course, if the markets are efficient, this will already be reflected in the market price and there will not be an opportunity for the investors to add value. But it is possible that the capital markets may not be very efficient in pricing ESG risks, as various studies[4] have indicated. If so, then investors may well be able to deliver better returns by taking account of ESG issues.

Investors also have a public interest motivation for singling out ESG issues. It is possible that capital market inefficiency on these issues may actually be doing social or environmental harm. For example, if the capital markets do not take account of environmental risks, then share prices will not fall when companies take big environmental risk, or rise when they take steps to reduce them. This may encourage company managers to take bigger environmental risks that they should, and reduces their incentives to exercise responsible environmental stewardship. This possibility is rendered more plausible by CEO complaints that few of their big investors show interest in their environmental and corporate governance activities, even when they would seem to have a material impact on the company.

So the idea behind the UN PRI commitment to integrate ESG issues into investment analysis and decision-making is that doing so will benefit investment returns, while also encouraging better corporate management of ESG issues.

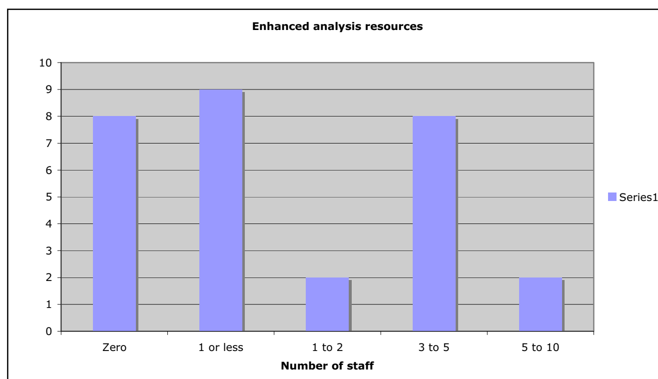
The survey indicators that the majority of managers seem to accept the legitimacy of taking account of these issues in analysis. 17 out of 22 respondents said that taking account of ESG issues is part of their formal investment process. In several cases, managers indicated that they have not historically separated out ESG issues from the many other issues they consider when analysing companies, but, nevertheless, they do believe these issues are significant from time to time, and do attempt to give them due weight.

16 out of 22 managers indicated that their analysis of ESG issues had influenced their decision to buy or sell securities during 2006. This is, on the surface, quite promising. However, the survey did not seek to elicit how frequently managers take account of these issues. So it may be that they take account of ESG issues only infrequently.

[4] **Paul A. Gompers, Joy L. Ishii and Andrew Metrick, 2001,** ***"Corporate Governance and Equity Prices",*** **National Bureau of Economic Research, USA; J. Derwall, N. Guenster, R. Bauer and Kees Koedijk, 2005, "***The Eco-Efficiency Premium Puzzle***", in the Financial Analysts Journal, Volume 61, Number 2.**

The survey also did not attempt to make a distinction between ESG issues which are well understood by the market and so about which the market may be quite efficient, and those that were not well understood. For example, some ESG issues like the risks facing tobacco companies from litigation are familiar to analysts and already likely to be factored in to security prices. Other ESG issues such as risks associated with the second phase of the EU Emissions Trading Scheme to tackle climate change are probably not well understood, given lack of data and uncertainty about permit prices. This distinction is important because the reasons for taking account of ESG issues offered above are both focused on those ESG issues that are *not* well understood by the markets. If the current ESG research activity captured by the survey relates mostly to well-understood ESG issues, rather than those that are under-researched, then it would not particularly valuable from either a fiduciary or a public interest perspective. This is to some extent borne out by the surveys finding that half the managers admitted having no evidence that there work on ESG issues had added any value to their investment performance.

Another way the survey has sought to reveal the extent of ESG activity is by looking at the resources deployed. The pattern for enhanced analysis is similar to that for engagement and voting, with the majority of manager having little or no dedicated resource focused on this topic, while a few invest fairly significantly.



This pattern is also visible in research budgets, with only half of managers having an internal research budget for analysis of ESG issues. However, internal research budgets are not the only means by which fund managers can fund research. Many rely heavily on research provided to them by sell-side brokers in return for research commission. According to the received wisdom at least, relatively little sell-side research has been devoted to the analysis of ESG issues. In 2004 a group of pension funds and asset managers, led by the Universities Superannuation Scheme set up the Enhanced Analytics Initiative (EAI)[5] to tackle this problem. Supporters of EAI commit to allocating 5% of their broker commission to rewarding ESG analysis by brokers. Among the managers who responded to this survey, only two are signatories of EAI. However, a further nine managers have opted to allocate a share of commission to pay for broker research on ESG. For large asset management houses, total commission runs to millions or even tens of millions of pounds. A small percentage share allocated to ESG, translates to a large absolute amount (one manager said they allocated £2m of commission to ESG). As a result of this spending, a number of the biggest brokers, including Goldman Sachs, UBS, Citigroup have established specialist teams focused on ESG research and there is now a steady flow of specialist broker research on topics such as climate change and governance.

[5] **www.enhancedanalytics.com**

APPENDIX 2 HARINGEY'S MANAGER RESPONSES TO 2007 GOVERNANCE SURVEY

	Fidelity International	Capital International	Alliance Bernstein
Coverage of SRI and Corporate Governance Policy with regard to equities			
Voting	no answer	all	all
Enhanced Analysis	all	all	all
Engagement	all	all	all
Screening	no answer	limited	limited
In which markets do you conduct voting activities?			
UK	no answer	extensively	extensively
Europe ex UK	no answer	extensively	extensively
North America	no answer	extensively	extensively
Japan	no answer	extensively	extensively
Emerging Markets	no answer	extensively	extensively
Other	no answer	extensively	
In which markets do you conduct extensive SRI Analysis?			
UK	extent unclear	extensively	extensively
Europe ex UK	extent unclear	extensively	extensively
North America	no answer	extensively	extensively
Japan	no answer	extensively	extensively
Emerging Markets	no answer	extensively	extensively
Other	no answer	extensively	
In which markets do you engaged?			
UK	extent unclear	extensively	occasionally
Europe ex UK	extent unclear	extensively	occasionally
North America	no answer	extensively	occasionally
Japan	no answer	extensively	occasionally
Emerging Markets	no answer	extensively	occasionally
Other	no answer	extensively	occasionally

	Fidelity International	Capital International	Alliance Bernstein
In which markets do you carry out Public policy activity?			
UK	occasionally	occasionally	none
Europe ex UK	occasionally	occasionally	none
North America	none	occasionally	none
Japan	none	occasionally	none
Emerging Markets	none	occasionally	none
Other	none	occasionally	
In which markets do you screen?			
UK	no answer	extensively	occasionally
Europe ex UK	no answer	extensively	occasionally
North America	no answer	extensively	occasionally
Japan	no answer	extensively	none
Emerging Markets	no answer	extensively	
Other	no answer	extensively	
Total number of staff dedicated to SRI and Governance			
	nine	ten	none
Allocation of their time			
Voting		50%	n/a
Engagement	30%	10%	n/a
Enhanced Analysis	59%	25%	n/a
Screened Fund Research		5%	n/a
Management of SRI Funds		0%	n/a
Public Policy Engagement	1%	5%	n/a
Communications and reporting of activity	10%	5%	n/a
Sales and Marketing		0%	n/a
Other		0%	n/a
Estimate the FTE of analysts and managers who spend >5% of their time on these matters			
	10		
Do you outsource any SRI/Governance activity?			
	no	no	No

	Fidelity International	Capital International	Alliance Bernstein
Level of engagement activity on SEE matters and outcomes in 2006 - UK			
No. of contacts with companies on SEE matters	85	no data	no data
No. of meetings held on SEE matters	65	no data	no data
No. of request to change policy/practice on SEE matters	70%?	no data	no data
No. of subsequent changes made	cannot quantify	no data	no data
Level of engagement activity on SEE matters and outcomes in 2006 - Overseas			
No. of contacts with companies on SEE matters	50	no data	no data
No. of meetings held on SEE matters	35	no data	no data
No. of request to change policy/practice on SEE matters	70%?	no data	no data
No. of subsequent changes made	cannot quantify	no data	no data
Levels of activity and outcomes on Governance issues - UK			
No. of contacts with companies	no data	no data	no data
No. of meetings held with companies on governance issues	no data	no data	no data
No. of request to change policy/practice	no data	no data	no data
No. of subsequent changes made	no data	no data	no data
Levels of activity and outcomes on Governance issues – Overseas			
No. of contacts with companies	no data	no data	no data
No. of meetings held with companies on governance issues	no data	no data	no data
No. of request to change policy/practice	no data	no data	no data
No. of subsequent changes made	no data	no data	no data
Do you publish a report on your engagement activity?			
	yes	yes	no
Please indicate the votes cast - UK			
No. of companies where votes cast	no data	508	93
Total no. of votes cast	no data	2526	n/a
Abstentions	no data	33	n/a
Against management	no data	112	n/a
No. of companies contacted to discuss resolutions	no data	no answer	n/a

	Fidelity International	Capital International	Alliance Bernstein
Please indicate the votes cast – Europe ex UK			
No. of companies where votes cast	no data	600	151
Total no. of votes cast	no data	2350	n/a
Abstentions	no data	5	n/a
Against management	no data	113	n/a
No. of companies contacted to discuss resolutions	no data	no answer	n/a
Please indicate the votes cast – North America			
No. of companies where votes cast	no data	778	170
Total no. of votes cast	no data	4660	n/a
Abstentions	no data	2	n/a
Against management	no data	192	n/a
No. of companies contacted to discuss resolutions	no data	no answer	n/a
Please indicate the votes cast – Japan			
No. of companies where votes cast	no data	395	139
Total no. of votes cast	no data	1900	n/a
Absentions	no data	0	n/a
Against management	no data	27	n/a
No. of companies contacted to discuss resolutions	no data	no answer	n/a
Please indicate the votes cast – Emerging Markets			
No. of companies where votes cast	no data	1035	130
Total no. of votes cast	no data	4099	n/a
Absentions	no data	202	n/a
Against management	no data	379	n/a
No. of companies contacted to discuss resolutions	no data	no answer	n/a
Please indicate the votes cast – Other			
No. of companies where votes cast	no data	539	123
Total no. of votes cast	no data	2018	n/a
Absentions	no data	3	n/a
Against management	no data	220	n/a
No. of companies contacted to discuss resolutions	no data	no answer	n/a

	Fidelity International	Capital International	Alliance Bernstein
Do you have a Stock Lending programme?			
	yes	no	no
Do you recall stock in order to vote?			
	yes	yes	yes
Do you do this all of the time?			
	yes	no	no
Do you publicly disclose your voting decisions or recommendations?			
	yes	no	no
Is analysis of governance and SEE issues part of your investment philosophy and process?			
	SEE issues are	yes	yes
Do you allocate brokerage commission for sell side analysis for SEE?			
	yes	no	yes
Total commission allocated to governance/SEE issues	not disclosed	n/a	n/a
Proportion of total commission that represents	Not disclosed	n/a	less than 1%
Do you have an in house budget for research on governance and SEE issues?			
	no	no	no
Has analysis of governance and SEE issues influenced buy/sell decisions?			
	yes	yes	yes
Do you have any evidence that it has led to better performance?			
	yes	yes	no
Have you participated in any government consultation or lobbying on governance or SEE issues in the last year?			
	yes	yes	no
Have you submitted a formal response to any consultant exercises?			
	yes	yes	no
Have you written to ministers on governance or SEE issues?			
	no	yes	no
Do you provide specialist SRI/Governance services to Pension Funds (eg screening, focus funds etc)?			
	no	yes	no

	Fidelity International	Capital International	Alliance Bernstein
Are you a signatory/organisational member of any of the following?			
UN Principles for Responsible Investment	under review	no answer	no
UNEP Finance Initiative	no answer	no answer	no
International Corporate Governance Network	no answer	yes	no
Enhanced Analytics Initiative	no answer	no answer	no
UK Social Investment Forum	yes	no answer	no
Eurosif	past member	no answer	no
Association of British Insurers	no answer	no answer	no
Global Reporting Initiative	no answer	no answer	no
Carbon Disclosure Project	yes	no answer	no
Institutional Investors Group on Climate Change	no answer	no answer	no
Other	EITI	UK RIN	no

APPENDIX 3 OVERLAY STRATEGIES: PROVIDERS' SUBMISSIONS

Submissions have been provided by:

- F & C Investment Management
- Governance for Owners' Stewardship Service
- Hermes Equity Ownership Services

F & C INVESTMENT MANAGEMENT

INTRODUCTION

F&C brings to its clients a long and distinguished track record as a leader in responsible investment. F&C was the first asset manager to develop a responsible ownership product and has an unrivalled, global track record as an active shareholder. F&C is able to offer a fully-integrated proxy voting and shareholder engagement service that is genuinely global in scope, but can offer both these services independently. Our approach to engaging companies is pragmatic and constructive, designed to achieve environmental, social and governance change that enhances the bottom line, rather than imposing prescriptive demands on companies.

F&C has the largest Governance & Sustainable Investment team in Europe with 15 dedicated experts, and an exceptional list of clients for our responsible engagement overlay. F&C specialises in allowing clients to pursue a rigorous and consistent approach to voting and engagement. This helps a pension fund that has multiple fund managers to ensure that their total holdings in a company are mobilised to maximum effect in engagement while also ensuring that the fund managers do not accidentally cancel out each other's votes by inconsistent voting. It means that the pension fund need only monitor the performance of F&C in this area, rather than many fund managers, for most of whom it will not be a priority area of activity.

OUR PRODUCTS

F&C is able to develop and implement a Responsible Investment Strategy for institutional asset owners which ensures they follow the best practices in responsible ownership. The following is a short summary of the services F&C can implement.

The construction of a comprehensive Responsible Investment Strategy begins with the articulation of a set of Principles, Strategy and Policies which outline the basic philosophy that underpin the all actions taken through the service. These are agreed in advance with the client. They are then put into effect by choosing from a number of possible Modules. This system provides our clients with the maximum flexibility to implement a Responsible Investment Strategy which is most appropriate for their positioning vis-à-vis their clients/beneficiaries and the general public.

- Modules 1 and 2 – **Voting** and **Engagement**, represent the basic "bread and butter" of a Responsible Investment Strategy. They offer pension funds the opportunity to adopt a comprehensive, balanced and consistent approach across the whole of their holdings which focuses on using their influence as shareholders to effect positive change in corporate behaviour. The fundamental underlying principle in both streams of activity is that prudent management of ESG risks enables companies to protect and enhance long-term shareholder value, and that it is the role, and indeed the fiduciary obligation, of institutional investors to communicate clearly to companies that such a long-sighted outlook is valued and rewarded by the market. F&C can provide both services individually or, as we recommend, combined through a fully-integrated Responsible Investment Strategy.

Voting and Engagement are the core part of a Responsible Investment Strategy – and the option most funds take – but F&C can also provide further services, which when implemented position a fund at the forefront of responsible, sustainable investment:

- Module 3 – **Ethical Exclusions**, affords clients an opportunity to identify a carefully-selected set of companies associated with certain highly controversial practices or activities, in order to exclude them from their portfolios. The rationale for such an approach is one of protecting them and their clients from reputational risk where engagement is not a viable approach. Therefore, this approach quite explicitly avoids any consideration of shareholder value, on the argument that such activities are simply unacceptable for reasons of principle (e.g. manufacture of cluster bombs).

- Module 4 – **Engagement-Led Divestment**, takes Engagement to its next logical step, by addressing instances where, despite sustained efforts to engage companies involved in activities deemed deeply unacceptable (e.g. child labour, extreme/irreversible environmental damage), the company's response has been unsatisfactory. Inefficiencies in the market mean that such behaviour may not be material enough in a financial sense to prompt the fund manager to dispose of the stock. Therefore, much like the Ethical Exclusions approach, the decision to divest must be taken for reasons of principle, and only in extreme circumstances in order to avoid unduly harming fund performance. However, unlike the Ethical Exclusions approach, these highly controversial activities do, over time, threaten shareholder value and are an appropriate subject on which to engage.

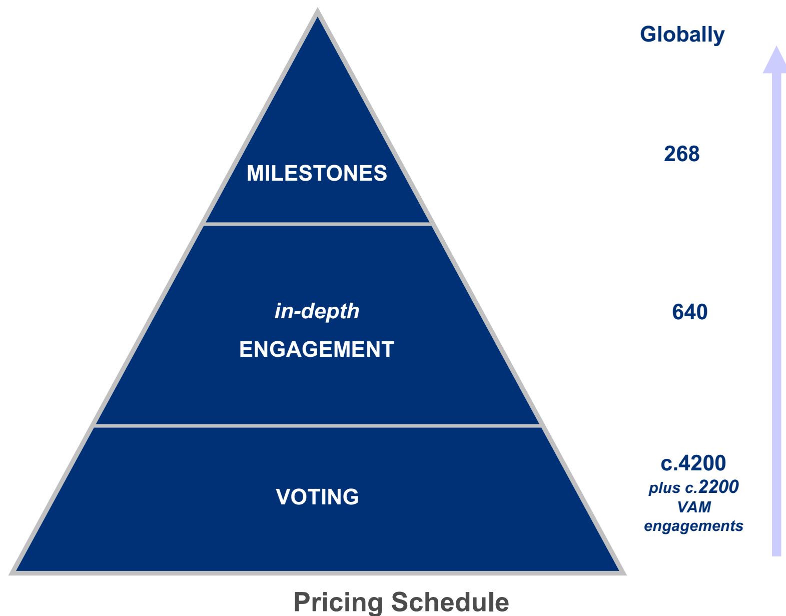
Pension Funds must not only fulfil their fiduciary obligations to their clients they must also ensure that their actions in this area are widely known and understood by both their beneficiaries and the wider public. Our **Reporting and Communication** ensures that F&C gives them the tools they need to fulfil that requirement. We will provide monthly, quarterly and annual reports, as well as meetings with staff, clients and/or their beneficiaries so that we ensure that our client's needs are fully met.

Number of Companies Engaged by Issue 2006

Issue	Companies engaged	% of engagement
Board structure, remuneration, capital, internal controls, shareholders rights	413	34%
Transparency & Performance	195	16%
Human Rights	65	6%
Labour Standards	102	9%
Bribery & Corruption	125	10%
Environmental Management	111	9%
Climate Change	120	10%
Biodiversity	69	6%
Total	**640[6]**	**100%**

[6] **This figure represents the total number of companies engaged rather than the sum of the above rows, as several companies have been engaged on more than one topic.**

Engagement hierarchy: from voting to milestones (company change)



Pricing Schedule

Standard *reo*® fee structure: Voting & Engagement	
Up to £150 million:	**(fixed minimum fee: £75,000) 5 bp**
£150 million to £750 million:	**2 bp**
£750 million - £2 billion:	**0.5 bp**
£2- 7 billion:	**0.2 bp**
> £7 billion:	**0.1 bp**
For a £290m portfolio:	
1st £150m:	**£75,000**
£150 - 290m:	**£28,000**
Total	**£103,000**

Voting & Engagement

- Integrated service per standard ***reo***® fee structure in box above: **£103,000**
- Engagement only: 25% rebate *£77,250*

The fees for the further services are on application, with consideration to the specific services required and the size of the client.

INTRODUCTION TO GOVERNANCE FOR OWNERS' STEWARDSHIP SERVICE

Governance for Owners (GO) is an independent partnership between major institutional share owners, a long-term financial backer and GO's senior executives. GO's approach to corporate governance is value driven and is predicated on the belief that companies with well informed, responsible share owners who enter into dialogues with boards and management teams are more highly valued over the long term than those with 'absentee' shareholders.

The GO Stewardship Service (GOSS) provides governance and engagement support to pension funds and other institutional investors committed to responsible, long-term investment. GO believes that making a highly experienced team available to clients, and co-ordinating share ownership activities, can enhance effectiveness, avoid duplication of effort and allow long-term investors to exercise positive influence over companies and in markets. Our aim is to provide a level of service in terms of flexibility and responsiveness that is similar to that which clients would expect from an in-house governance team. Clients decide the degree of their own involvement.

GOSS is more than a voting solution. It is intended to provide clients with a value-adding (rather than compliance-oriented) approach to voting and engagement and offers a progressively more resource intensive range of engagement activities designed to add value to clients' portfolios. Our aim is not just to register concern by advising clients to vote against management but to bring about fundamental change at companies with weak governance practices.

GOSS does not put equal weight on governance, environmental and social issues but considers environmental and social matters as part of its governance analysis. We believe strongly that it is not the role of share owners to micro-manage companies but to monitor, and if concerned try to influence, the approach taken by boards to key business issues.

Our engagements with companies, whether through telephone conversations, written correspondence or face-to-face meetings are intended to increase understanding by the board and management as to the key concerns of shareholders in relation to the company. We aim also to agree with the company steps to take, and a time frame for taking them, that will enable us to recommend to clients that they support management in future. Our engagements can be divided into two main categories. Structural engagements focus on issues widely considered to be core governance matters such as disclosure, authority to issue shares, executive remuneration, and board processes. Strategic engagements focus on matters more directly linked to value creation such as board composition and calibre, strategic direction and delivery and financing.

We believe that to vote intelligently and engage effectively with companies it is important to have a local presence. Accordingly, we have a team of European nationals in London to cover Europe, and teams in the US and Japan to cover their respective markets and in Singapore to cover Asia.

For a portfolio of the indicated value and number of stocks, and assuming straightforward portfolio arrangements, GOSS would cost approximately £125,000 for a full voting and engagement service including assistance as required with policy development for each market, additional support on policy consultations and reporting.

HERMES EQUITY OWNERSHIP SERVICES

Hermes Equity Ownership Services (EOS) offers a comprehensive and unified responsible investment and corporate governance advisory service on a client's equity investments wherever they are managed.

VALUES AND VALUE

Companies with informed and involved shareholders are more likely to achieve superior long-term performance than those without. Being an involved shareholder does not mean insisting upon compliance with a set of rules or box-ticking. EOS aims always to represent to directors a shareholder's perspective on the company's environmental, social and governance performance and to frame its discussions with companies in terms of long-term value creation.

RESOURCES AND COVERAGE

Hermes is unique in having recruited to its responsible share-ownership activities a team of highly qualified business people and professionals, whose diverse skills, specialisations and backgrounds contribute to the presence of a truly international team. Making realistic and realisable demands of investee companies, informed by significant hands-on experience of business management, corporate finance and strategy setting, is critical to our success.

Being an effective catalyst for positive change at companies requires considerable resources in terms of people and time. Hermes has more than 55 people (as at August 2007) involved in its responsible share-ownership activities on behalf of clients, 20 working full time within EOS. Intervention at a senior management and board director level should be carried out by individuals with the right skills and with credibility.

The depth and breadth of this resource reflects our philosophy that these activities are on a continuum and require a co-ordinated and appropriately skilled approach. This thinking has also been adopted in the United Nations Principles for Responsible Investment and in the Myners Report and the Institutional Shareholders' Committee's recommendations in the UK, all of which encourage institutional investors to act as owners of companies on behalf of their clients and beneficiaries.

EOS takes an integrated approach to responsible share ownership, from properly and intelligently casting votes at general meetings to actively engaging in order to help bring about change that will support improved performance.

Our clients' extensive international portfolios, covering some 4,500 companies internationally means that EOS professionals regularly engage with companies across the globe, whilst adapting their strategies to respect the specific circumstances of the companies, including the financial and legal environment in which they operate.

FIDUCIARY DUTY AND VALUE CREATION

Pooling resource through EOS allows like-minded long-term investors to undertake active share-ownership activities in an efficient and cost-effective way. EOS can deliver full voting coverage and high-quality engagements both with companies and with governments and regulators on policy matters, adding value and helping clients meet their fiduciary obligations to beneficiaries.

EOS is an unrivalled offering which achieves far more than the handful of voting execution and recommendation services currently available to pension funds. Our processes and people take company engagement well beyond the normal parameters of short term investor relations and the SRI that often define the boundaries of 'engagement'.

The fee structure for Hermes EOS is based on the value of the equities under advice. Fees will typically be in the range of 0.5 to 2.0 basis points, with a minimum charge of around £100k. Based on the information you have provided, with an equity value of c. £300m, the fee would be at or around the minimum charge.

APPENDIX 4 SUMMARY OF SEGREGATED EQUITY HOLDINGS

Equities	Lines of Stock	Value / GBP 000
Australia	17	5,130
Austria	2	372
Belgium	2	452
Brazil	1	114
Canada	15	2,889
China	4	675
Europe Region	2	147
Finland	3	455
France	18	14,439
Germany	14	12,635
Greece	1	171
Hong Kong	7	1,694
Ireland	5	1,919
Italy	3	1,614
Japan	67	24,183
Netherlands	10	9,242
North America Region	2	146
Norway	3	868
Philippines	1	65
Poland	1	130
Singapore	6	1,314
South Africa	2	138
South Korea	9	1,484
Spain	5	2,662
Sweden	3	1,416
Switzerland	10	7,431

Equities	Lines of Stock	Value / GBP 000
Taiwan	1	159
Thailand	1	123
United Kingdom	89	163,879
United State	123	34,606
Total Common Stock	**427**	**290,552**

APPENDIX 5 SUMMARY OF POOLED FUND HOLDINGS

Equities – Unit Trusts	GBP000	
Fidelity Inv SVCS Institutional Emerging Markets	10,044	Fidelity International Ltd
Capital International Emerging Markets	12,684	Capital International Ltd
Fidelity Inv SVCS Institutional Europe ex UK	32,612	Fidelity International Ltd
Fidelity Inv SVCS Institutional Japan	16,906	Fidelity International Ltd
Fidelity Inv SVCS Institutional Pacific (ex Japan)	8,827	Fidelity International Ltd
Fidelity Inv SVCS Institutional UK Multi Manager	33,154	Fidelity International Ltd
Fidelity Inv Man Institutional exempt America Multi Manager	32,206	Fidelity International Ltd
Bonds – Unit Trusts		
Capital International CIF Global High Yield	4,090	Capital International Ltd
Capital International UK Corporate Bond Fund	30,002	Capital International Ltd
Fidelity Inv SVCS Institutional UK LG Corporate Bonds	21,183	Fidelity International Ltd
Private Equity Partnerships		
AMB Europe Fund 1	1,347	Pantheon Ventures
Pantheon US Fund VII	1,593	Pantheon Ventures
Total	**204,648**	**About 33.3% of the Fund**
Equities	146,433	24%
Private Equity	2,940	0%
Bonds	55,275	9%

APPENDIX 6 CIPFA PENSIONS PANEL GUIDANCE NOTE NO 2

Pensions Guidance Notes
No 2
May 1999
CIPFA Pensions Panel

Management and Investment of Funds

Shareholder Responsibilities

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CIPFA is one of the leading professional accountancy bodies in the UK and the only one which specialises in the public services. It is responsible for the education and training of professional accountants and for their regulation through the setting and monitoring of professional standards. Uniquely among the professional accountancy bodies in the UK, CIPFA has responsibility for setting accounting standards for a significant part of the economy, namely local government. CIPFA's members work (often at the most senior level) in public service bodies, in the national audit agencies and major accountancy firms. They are respected throughout for their high technical and ethical standards, and professional integrity. CIPFA also provides a range of high quality advisory, information and training and consultancy services to public service organisations. As such, CIPFA is the leading independent commentator on managing and accounting for public money.

1 Introduction and Acknowledgements

The purpose of this note is to provide guidance relating to the investment of funds governed by the Local Government Pensions Scheme (LGPS) in respect of shareholder responsibilities regarding the corporate governance of companies and ethical investment criteria. Particular reference is made to:

- the legal requirements
- good practice on establishing and operating policies on these issues
- background information on the work of the committees reporting on the running of
- companies.

This guidance note is primarily for the Responsible Financial Officers of administering authorities but may be of interest to other parties, for example Responsible Financial Officers of employing authorities and admitted bodies. Responsibility for the guidance, and the views expressed in it, rests solely with CIPFA and it should not be relied upon by any third party in dealings with local authorities. Nor should it be relied upon as an authoritative interpretation of the law. CIPFA has published this guidance note through the work of its Pensions Panel. CIPFA wishes to thank members of the Panel for the work in its preparation:

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CIPFA is grateful also to Geoff Singleton for the background research and drafting he undertook before retiring from the Panel in 1998.

2 Legal Requirements

The Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998 and **the Local Government Pension Scheme (Management and Investment of Funds) (Scotland) Regulations 1998** are the governing regulations. In both sets of Regulations, **Regulation 9** relates to the use and investment of pension fund money. Other national legislation can impinge on the LGPS. However, at the time of preparing this guidance the relevant regulations are not overridden to any significant extent by any national legislation. In addition to the specific statutory functions (both duties and powers) as referred above, administering authorities have an obligation to properly perform those functions for their intended purpose. It has been long established that the elected members of a local authority are under a fiduciary duty to those who supply the funds that enable the authority to carry out its functions. This "fiduciary" duty is similar to the duty of a trustee. It is a duty to have regard to the best interests of the beneficiaries of the funds held and of those who supply the funds. The members of local authorities owe this duty generally to the council tax payers of their area and, in the case of pension administration, to the contributors and beneficiaries of the pension fund. This will include employer contributors, both scheduled and admitted bodies. Attention should be paid also to the Wednesbury Principles which would apply a test of reasonableness to a Fund's actions in pursuit of any particular policy. In regard to **regulations 9(4) and (5)**, the administering authority is required to obtain proper advice, which is defined in the **regulation 2** as "the advice of a person who is reasonably believed by them to be qualified by his ability in and practical experience of financial matters (including any suitable officer of theirs)."

The Responsible Financial Officer is recommended to obtain and consider professional legal advice in developing or pursuing any policies relating to corporate governance or ethical investment which appear to test the boundaries of existing practice or reasonableness. It may also be appropriate to consider advice on the investment issues from other professional or qualified persons.

3 Overview of Good Practice

Apart from the fiduciary duty placed on a trustee, and the investment regulations and practice relating to the investment process, public debate on corporate governance issues in recent years has led to widespread calls for trustees to accept greater responsibilities of ownership in how they act in their capacity as shareholders in public companies. Shareholders can influence the way in which companies are run (corporate governance) and their attitudes to social and environmental policies by exercising their votes in a particular way, by expressing views to those companies, and by the selection or deselection of investments of particular companies for these reasons. Where there are no specific rules or regulations regarding investment decisions, it is important to have regard to good practice as may be directed by Government, published by public committees, and exercised by other funds. These guidelines concern shareholder responsibilities which relate to both corporate governance and ethical investment insofar as these issues affect the running of companies in which pension funds invest. Local government, through local government pension funds, is a major investor and there is increasing interest in local authorities promoting and supporting high standards of corporate governance. The guidelines set out good corporate governance practice and refer to the way in which corporate governance has developed. With regard to ethical investment, there is a significant body of opinion which feels that the practice is relevant because of the benefits to society that can accrue. There are some significant legal issues which need to be borne in mind when considering ethical investment and the guidelines refer to these.

Following **the report of the Hampel Committee**, the Government encouraged investors to exercise their voting rights in the pursuit of good corporate governance and suggested the possibility of legislation to require shareholders to vote if practice did not improve. More recently, in the context of **the Government's green paper** "Partnership in Pensions" and accompanying **consultation paper**, the Government has proposed the introduction of a regulation under **the Pensions Act 1995** which would require pension fund trustees to set out their investment strategy relating to moral and social issues in their Statement of Investment Principles. Clearly good practice will continue to develop in the light of the pension industry's response to these issues and the Pensions Panel will keep this guidance note under review. To assist them in doing so, the Panel would welcome comments and notifications of changes from users of the guidance defined on page 4.

4 Corporate Governance in Companies

Definition and background

The term corporate governance is defined in the Cadbury Report as "the system by which organisations are directed and controlled". It embraces the way in which a company's affairs are managed and reported with particular reference to the composition and actions of directors and the interests of shareholders. The concept of corporate governance arose out of unease within the investing communities over the manner in which businesses in which they invested conducted themselves and the

consequent implications for long-term shareholder value particularly where this led to corporate collapse. Institutional shareholders in the USA have been very pro-active in promoting improvements in corporate governance. During the 1990s the issue came to prominence in the UK on the back of disquiet arising from the large pay increases given to executives on the privatisation of public utilities, greater globalisation of securities markets and the growing influence of institutional investors within the UK stock market. Many observers regarded the apparent acquiescence of the large institutional investors
to indifferent corporate performance as unhealthy. In order to pre-empt further criticism and in an attempt to create some standards within the market place a number of committees were established which reported upon the subject. By far the most important were, in chronological order of establishment, the Cadbury Committee, the Greenbury Committee and the Hampel Committee. The last reported in January 1998 and its recommendations were appended to the Listing Requirements in June 1998. A synopsis of the Committees and the Listing requirements is attached as **Appendix 1**. A framework, therefore, exists within which the boards of companies should manage their corporate affairs. These are now seen as minimum standards by most observers. In addition, of course, the provisions of the Companies Acts apply. If an administering authority considers that improved standards of corporate governance would bring benefits to its pension fund it should consider adopting a positive approach to the promotion of high standards and formulate a policy to achieve this. Pressure can be exerted on companies to adopt high standards of corporate governance in a number of ways, including discussion with management and by exercising voting rights. Those administering authorities which wish to adopt a positive approach will go further than simply avoiding purchasing shares in problem companies and selling shares when problems become apparent and should consider the following:

- establishing a corporate governance policy
- establishing voting policies and making arrangements for votes to be cast at AGM/EGMs
- encouraging investment managers to address companies on corporate governance
- issues which ultimately enhance shareholder value
- establishing contact with companies using various means such as writing letters or
- attending meetings.

Although the requirements of **the Pensions Act 1995** concerning Statements of Investment Principles (SIPs) do not apply to the Local Government Pension Scheme (LGPS) they nevertheless constitute good practice. Where SIPs are introduced the administering authority's approach to corporate governance policy should be explained within them.

Legal issues

Since most corporate governance issues are addressed by using existing shareholder rights there should be no overriding legal concerns provided action is being taken in the interests of beneficiaries.
However, the Responsible Financial Officer should have regard to the reasonableness of any costs involved in such action and any detrimental effect on shareholder value.

Establishing a policy

In deciding whether to establish a corporate governance policy, the Responsible Financial Officer should consider, record and report to an appropriate committee of the administering authority:

- whether pursuit of such a policy in seeking to protect their rights as shareholders will be
- effective in minimising the risk of poor corporate performance or corporate failure
- whether there are reasonable grounds for presupposing that the active exercise of the
- pension fund's existing shareholder rights will have a reasonable prospect of ultimately
- producing returns which will be superior to those achieved otherwise over reasonable
- time periods
- whether the additional costs, if any, of such a policy are reasonable.

Implementation of a policy

In implementing any corporate governance policy, the Responsible Financial Officer should ensure that:

- clear objectives, limitations and targets are given to the manager and/or custodian in all
- cases
- the appropriate committee of the administering authority receives reports on the way in
- which votes have been cast and any responses received from companies.
- voting performance and efficiency of execution is reported on wherever possible.

Policy review

If an administering authority has adopted a policy, the Responsible Financial Officer should ensure that the policy is reviewed regularly and reported on to an appropriate committee. Consideration should be given to publishing the policy and supplying copies of it to the companies in which the fund is invested.

Matters worthy of consideration in developing a policy

It is, of course, a matter for each administering authority to determine which, and how many, issues it wishes to include in its corporate governance policy or, indeed, whether to adopt a policy or not. For those that decide to adopt a policy it is suggested that the issues outlined in **Appendix 2** constitute the majority of those which the Responsible Financial Officer should consider including.

These are intended solely to draw the attention of the Responsible Financial Officer to these issues and are not put forward by CIPFA as positive recommendations. Furthermore, some comments need to be read in the context of the original reports and commentaries. It should

be borne in mind that corporate governance issues will evolve over time with the development of good practice and legislation.

External advisors

Various external providers exist who can assist with the formulation of corporate governance policies and provide information services. The two most commonly used are the services provided by the National Association of Pension Funds and Pensions and Investment Research Consultants. Some fund managers have developed systems for in-house clients. In addition some companies, e.g. Manifest, provide a voting and execution service.

Execution of policy

Once established, the execution of a policy is equally important. The two most common approaches are to contract with either the pension fund's investment managers or with its custodian(s) to carry out voting instructions in accordance with an agreed policy. These may in turn, though, sub-contract the work to a specialist service provider. These organisations are usually independent companies which place instructions with registrars based upon a policy template received from the client fund.

The range and effectiveness of the services provided by the parties vary enormously and the Responsible Financial Officer should ensure that the fund's needs are clearly stated within all relevant contracts. Wherever possible, provision for a full voting audit trail should be provided, e.g. certified records showing how the fund cast its votes at each meeting, be it AGM or EGM, for every appropriate fund investment. It should be borne in mind that even though the custodian and/or investment manager might have executed the client's votes in the correct manner, it is the responsibility of the company's registrar to ensure that the votes are recorded. However, registrars are under no obligation to report back on the votes cast and a comprehensive audit service identifying detailed voting records is not a service universally provided at present. There is frequently a cost involved in executing votes including administration time. Again, this is a matter for each pension fund to negotiate with its service provider. Historically, few fund managers and custodians have included these sort of services within their traditional remit. Some have shown a marked reluctance to enter into the market. If custody is an "in-house" activity the implications for resources, particularly staffing, need to be carefully assessed. There might be occasions when it would be appropriate for funds to co-ordinate their responses and act in concert as well as promoting general issues of corporate governance. Existing lobbying organisations can assist in this to some degree.

5 Ethical Investment

Definition and background

Ethical investment for the purpose of this guidance is defined as the practice of selecting or deselecting investments by reference to any criteria other than financial ones, e.g. moral,

environmental, social, political. By their very nature such criteria are subjective and/or matters of opinion. Consequently, guidance of an all embracing nature cannot be provided.

Legal issues

There is no current statutory prescription or legal precedent which provides a clear reference point on ethical investment. There are, however, a number of considerations which need to be borne in mind. Pension funds should only be used for the purpose of meeting proper pension fund liabilities. With regard to the Local Government Pension Scheme this requirement is set out in regulations. The regulations do not specifically prohibit ethical investment by local government pension funds, neither is it specifically permitted. The duty of trustees to their beneficiaries is paramount to any personal interests or views. The criteria involved in ethical investment are inevitably open to subjective judgement and opinion, and are not capable of the same limitation by quantifiable definition as would be financial criteria. In the case of pension fund investments, the best interests of beneficiaries are normally financial interests. Particular attention needs to be given, therefore, to the achievement of financial returns and the control of risk associated with such investment criteria. The administering authority must act reasonably, having regard to all relevant considerations and no irrelevant ones, and must not come to a decision that no reasonable body would come to.

Establishing a policy

A number of pension funds have developed and applied an ethical investment policy. Typically, any such policy is likely to be applied to a part of the fund only, and, in that respect, be regarded as another specialist asset category rather than as an overriding investment criterion. This is particularly relevant bearing in mind the legal requirements that an administering authority's investment policy must be formulated with a view to the advisability of investing fund money in a wide variety of investments [**Regulation 9(3)(a)**]. In deciding whether to establish an ethical investment policy, the Responsible Financial Officer should consider, record and report to an appropriate committee of the administering authority:

- whether there are reasonable grounds for expecting that the pursuit of investments
- based on whatever criteria have been selected has a reasonable prospect of producing
- returns which will be comparable to those achieved by an unrestricted portfolio over
- reasonable time periods
- whether an appropriate performance target above that of an unrestricted benchmark
- would be required to reflect any higher risk
- what prudent limits should be applied to the exposure to such a policy in a diversified
- fund
- whether there are additional costs of such an investment strategy and if so whether they
- are reasonable.

Implementation of a policy

In implementing an ethical investment policy, the Responsible Financial Officer should ensure
that:

- clear objectives, limitations and targets are given to the manager in all cases
- investment performance and returns are measured formally over reasonable time
- periods
- if external managers are to be used, they are selected, appointed and monitored in
- accordance with the fund's normal selection procedures as set out in the LGPS
- Regulations.

Policy review

Where an administering authority has adopted an ethical investment policy, the Responsible Financial Officer should ensure that the policy is reviewed regularly and reported to an appropriate committee together with the results of performance measurement.

Statement of Investment Principles

Although the requirements of **the Pensions Act 1995** concerning Statements of Investment Principles (SIPs) do not apply to the LGPS, they nevertheless constitute good practice. Where SIPs are produced, the fund's approach to ethical investment should be explained within them. This is further endorsed by the Government's proposal in **the consultation document** "Strengthening the Pensions Framework" to introduce a regulation under **the Pensions Act**. The relevant extract is in **Appendix 3**.

Appendix 1

The Committees and the Listing Requirements

1 The Committees

i) Cadbury Committee

The Cadbury Committee was formed in June 1991, and reported fully in December 1992 with recommendations effective from the year ending 30th June 1993.
Main points:

- companies should report on whether they comply with **the Cadbury Code** and if not, why
- not
- there should be a division of responsibility at the head of the company, and if posts are
- combined, there should be a strong independent element on the board
- there should be at least three non-executive directors, a majority of whom should be
- independent (ie free from any business or other relationship with the company)
- non-executive directors should be appointed by a formal process
- service contracts should not be for more than 3 years without shareholder approval
- there should be full disclosure of total emoluments and separate figures for salary and
- performance elements for the chairman and highest paid director
- there should be a remuneration committee comprised of a majority of non-executive
- directors
- there should be an audit committee, composed of at least 3 non-executive directors, a
- majority of whom should be independent
- there should be statements of directors' responsibilities, internal controls and going concern
- votes are an asset and voting policies should be disclosed.

ii) Greenbury Committee

The Greenbury Committee was formed in January 1995, and **reported fully in July 1995**, with recommendations largely effective from 1996, though with a phasing in period for stock exchange listing rules on long term incentive plans, and pensions. Main points:

- companies should state whether they have complied with **the Cadbury Code** and if not, why
- not
- remuneration committees should be formed, solely non-executive and independent
- remuneration committees should report to shareholders
- full disclosure on all elements of remuneration for all directors
- pay should not be excessive
- all new share schemes should be voted on
- new schemes should replace rather than supplement existing schemes
- pension entitlements to be disclosed
- service contracts to be no more than one year (with exceptions)

- mitigation should be applied to compensation payments
- performance targets for incentive schemes should be stretching
- no options to be issued at a discount.

iii) Hampel Committee

The Hampel Committee was formed in November 1995, and **reported fully in January 1998** with recommendations effective from the reporting season 1999. Main new points (other than consolidation of **Cadbury** and **Greenbury**):

- directors should receive training
- the board should have at least one third non-executive directors
- directors should identify the posts of chairman, chief executive, independent non-executive
- director and senior non-executive director
- nomination committees should be formed, a majority to be non-executive directors
- all directors should be elected regularly, at intervals of no more than 3 years
- boards should set one year contracts as their goal
- boards should consider liquidated damages in contracts rather than mitigation
- companies should announce proxy votes at AGMs
- all resolutions should be separate
- AGM notices should be sent at least 20 working days
- boards should review the need for internal audit function
- investors should report on their overall voting levels.

2 The Combined Code and Listing Requirements

The Hampel Code has been translated and recommendations have been appended to listing requirements by the Stock Exchange and renamed **the Combined Code**. **The Combined Code** consists of 17 Principles and 48 accompanying Provisions which explain how the Principles should be applied. For the reporting season 1999, companies will have to make a statement of how they have applied the Principles and provide a statement of whether they have complied with the Provisions and identify any areas of non-compliance. The content of the Principles and the Provisions largely follows that contained in **the final Hampel Report**. It also consolidates **the Cadbury and Greenbury Codes** with only minor changes to existing best practice. New requirements include:

- the chairman, chief executive and senior independent director should be identified in the
- annual report
- non-executive directors should comprise not less than one third of the board
- the establishment of a nominations committee
- all directors should be subject to re-election at regular intervals and at least every three
- years
- procedures at AGMs regarding the announcement of proxies and the form of resolutions.

However, some observers believe that there are a number of corporate governance issues of concern to shareholders that have been left untouched. The limitations of **the Combined Code** mean that these issues, if considered to be important, will need to be pursued by individual funds, directly with companies and via the government's review of company law.
Some observers further suggest that the Stock Exchange will not have the resources to monitor and enforce compliance. This responsibility will, it is argued, continue to rest mainly with institutional shareholders.

Appendix 2

Issues Worthy of Consideration Regarding a Corporate Governance Policy

The following topics are put forward for consideration by the Responsible Financial Officers when formulating corporate governance policies. They are not exhaustive, neither do they specify any particular policy to adopt. It is a matter for each administering authority to determine what it should, or should not, include in such a policy.

1 Report and Accounts

Do the documents meet industry best practice? If a particular issue of concern has arisen with a company which has not been satisfactorily resolved, the opportunity could be taken to vote against adoption whilst at the same time sending an explanatory letter to the company.

2 Dividend Policy

Is the proposed dividend adequately covered?

3 Executive Directors

Are directors subject to regular re-election? Three years is the normal period Do the directors have reasonable service contracts?
Is the director aged 70 years or over?
Is there clarity of roles and responsibilities?
Where the roles of chairman and chief executive are filled by one individual, is an explanation provided since best practice suggests that the roles ought to be split?
Remuneration packages and mechanism for renewal: the mechanism for the appointment of directors (both executive and non-executive) should be transparent.

4 Non-executive Directors

Are the non-executive directors truly independent?
Are there enough non-executive directors on the board to provide balance?
Are the non-executive directors subject to re-election?
For what period are they appointed and what is their remuneration?
Is a senior independent director identified within the report?
Is there clarity of roles and responsibilities?
Is induction and on-going training provided for non-executive directors?

5 Remuneration Packages

Is there a reasonable explanation of how remuneration packages for directors are determined and do they comply with the current codes of practice?
Does the membership of the remuneration committee comply with best practice?
Does the annual report fully disclose company remuneration policies?

6 Share Options/Long Term Incentives

Are these reasonable in the context of the work force as a whole?
Are the targets upon which they are based directly relate to enhanced shareholder value?

7 Remuneration, Audit and Nomination Committees
Consideration should be given as to whether the makeup and procedures of these committees are appropriate.

8 External Auditors
Are the auditors independent?
Do they earn more in fees for non-audit work than for audit work?
Does the company have the appropriate audit committee structure in place?

9 Internal Controls and Standards of Behaviour
Is there an internal audit function?
Are there effective risk management procedures and internal control mechanisms?
Are there policies on integrity and codes of conduct, systems for dealing with complaints and "whistleblowing" schemes?

10 Split Share Structures
Does the share structure disadvantage the majority of shareholders?

11 Take-overs
It should not be presumed that take-overs automatically enhance shareholder value.

12 Political and Charitable Donations
Do such donations contribute towards shareholder return?
Have shareholders been given the opportunity to vote on political donations?

13 Investment Trusts
Different corporate governance guidelines may be appropriate to investment trusts when compared to other companies.

14 Specific Issues
Other issues such as third world exploitation, peat etc, need to be identified separately. Care ought to be taken to distinguish between ethical and corporate governance issues.

Appendix 3

Extract from the DSS Consultation Document "Strengthening the Pensions Framework"

"30 ETHICAL INVESTMENT
It is important that pension schemes consider in a positive way how their funds are invested. We believe that trustees should be free to consider moral and social issues in relation to their investments, provided trustees adhere to the obligations placed on them by trust law and always put the beneficiaries' interests first. We believe that the most effective way of bringing this policy into effect would be to introduce a regulation under **the Pensions Act 1995**. The regulation would require pension fund trustees to set out their "investment strategy relating to moral and social issues", if any, in their Statement of Investment Principles, required under **section 35 of that Act**. We would welcome views on the following draft:

Content of statement of investment principles

For the purposes of **section 35(3)(f) of the 1995 Act** (other matters to be contained in the statement of investment principles), the statement must cover whether the trustees take into account any considerations other than financial considerations, and if so, what these are and how investment decisions are affected."