

Mr Glenn Fallows
IGG Secretariat

By email to: glenn.fallows@thepensionsregulator.gsi.gov.uk

5 May 2010

Dear Glenn,

FairPensions welcomes this opportunity to respond to the IGG's consultation paper, *'Investment governance of defined contribution (DC) pension schemes'*. FairPensions is a project of The Fairshare Educational Foundation, a registered charity (no 1117244) established to promote Responsible Investment by UK pension schemes and fund managers, and to ensure that the ultimate beneficiaries are well served by institutional investors and other professional agents in the investment world.

FairPensions is a member organisation. Our members include organisations representing the beneficial owners of pension schemes, such as the Occupational Pensioners Alliance, UNITE and Unison, as well as thousands of individual pension fund members.

We believe that effective corporate governance is essential to the protection of beneficiaries' assets and the long-term health of the wider economy. We have a history of engagement with the post-financial-crisis reviews of this issue, including the Walker Review and the FRC's consultations on the Corporate Governance Code and the Stewardship Code. All of our previous submissions can be found on our website at <http://www.fairpensions.org.uk>.

Introduction

Our primary comment on the proposed Principles relates to the relegation of Myners Principle 5, Responsible Ownership, to a weaker best practice guideline. Accordingly, the bulk of our response addresses this issue, under the thematic heading 'General comments on Responsible Ownership'. However, our remarks in this section could also be considered as our response to Questions 7a) and 7c) in the consultation paper.

We also respond directly to certain consultation questions which fall within our remit, namely Questions 1a), 1d), 2 and 6.

General comments on Responsible Ownership

We are concerned by the removal of Myners Principle 5, 'Responsible Ownership', and its replacement with a 'best practice' guideline under new Principle 1, 'Clear roles and responsibilities'.

This would appear to signal to pension scheme decision-makers and to scheme members that the importance placed on Responsible Ownership has been downgraded. The consultation paper makes clear that best practice guidance will not have the same status as the Principles themselves. While scheme decision-makers are expected to apply the principles on a 'comply or explain' basis, it is stressed that "decision-makers are not expected to implement every element of 'best practice' all of the time." With Responsible Ownership now downgraded to best practice guidance, the

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implication is that responsible ownership is an optional extra for DC funds, rather than an essential component of good governance.

Active share ownership and long-termism were central themes in the original Myners Review. Their importance has recently been powerfully reiterated in the Walker Review recommendations and in the FRC's Consultation on a Stewardship Code. It is widely acknowledged that among the causes of the financial crisis, and the losses in DC pension fund holdings arising from the crisis, was inadequate scrutiny of companies on the part of large institutional investors. Whilst younger DC scheme members have seen the value of their pension savings rebound considerably since the low point of the financial crisis, many people who were on the point of retirement at the time of the crisis will pay a high price into their old age. With that experience so recent, we are surprised that the IGG's DC subgroup should propose to downgrade Responsible Ownership in these proposed new Principles.

The wording of the proposed best practice guideline is also weaker than that of Myners Principle 5. The original principle read:

Trustees should adopt, or ensure their investment managers adopt, the Institutional Shareholders' Committee (ISC) Statement of Principles on the responsibilities of shareholders and agents. A statement of the scheme's policy on responsible ownership should be included in the Statement of Investment Principles. Trustees should report periodically to members on the discharge of such responsibilities. (emphasis added)

However, the best practice guideline says merely that decision-makers should:

Take into account the Institutional Shareholders' Committee Stewardship Code in adopting a policy on Responsible Ownership (to the extent that it is practical in the context of the funds offered or under consideration), monitor its implementation and report on it to interested parties (including members and member representatives)

It is unclear why this change in wording is felt to be necessary. It is difficult to argue that the wording of the updated Myners Principles is too prescriptive, given that the implementation of best practice guidelines is considered optional in any case. Indeed, even the 'comply or explain' framework applied to the Principles themselves offers ample flexibility for schemes with a genuine reason for taking a different approach to do so. In the case of equity holdings, we find it hard to envisage why schemes acting in the best long-term interests of members would have good reasons not to implement the essential components of Responsible Ownership, namely shareholder activism through dialogue, reinforced by the potential exercise of shareholder powers.

A further result of the downgrading of Principle 5 to a best-practice guideline is the loss of the best practice guidance to Principle 5 itself, which included giving consideration to the role of engagement and ensuring that investment consultants adopt the ISC's Statement of Practice. We consider that the IGG's objective of updating the principles "to reflect the nature and qualities that are specific to the DC pension environment" should be achieved through providing further guidance rather than less.

We question what has changed to justify this proposed departure from the 2008 updated principles. If the value of active share ownership and long-termism in investment strategy is accepted, Responsible Ownership's contribution will apply irrespective of the kind of scheme held, whether the distinction is DC or DB, self-administered or insured, trust-based or contract-based.

Active ownership, which should be undertaken to both protect scheme members assets and to enhance the value of such assets, undoubtedly involves effort on the part of fund managers. In DC schemes members bear the long-term investment risks, whereas in DB schemes the employer bears the investment risk. It is not clear why the long-term investment protection and value

enhancement arising from Responsible Ownership should be deemed appropriate for DB schemes but not for DC schemes.

In this respect, it is worth remembering that the original separate DC and DB scheme principles in the Myners Review each contained similar principles relating to 'activism', and the same was true of the final versions adopted by the Government in 2001. Likewise, when the proposed revisions to the DB principles were published following the Government review in 2004, it was explicitly stated that corresponding changes would be made to the principles for DC schemes.

We therefore recommend that Responsible Ownership should be reinstated as a principle in its own right. As an absolute minimum, the wording of the proposed best practice guideline should be strengthened to reflect the wording of the updated Myners Principles. However, we would stress that it remains our firm view that a best practice guideline is insufficient and out of step with current thinking on investment governance.

FairPensions' response to consultation questions

Question 1(a)

Further to our comments about the downgrading of Responsible Ownership, we would also suggest that the role of agreeing a policy on Responsible Ownership, monitoring its implementation and reporting on it to interested parties should be covered in the table of accountabilities.

We are concerned that this does not currently seem to be covered under any of the decisions or processes listed. We also note that the table of accountabilities makes no explicit reference to managing risk, although it does refer to "agreeing investment objectives" and "monitoring of investment performance of funds". Again, given the experience of the financial crisis and its detrimental impact on many pension scheme members, we feel that some explicit wording about ultimate responsibility for monitoring and managing investment risk is needed in this table.

Question 1(d)

We welcome the recognition, in best practice guideline 3 to Principle 1, of the importance of managing conflicts of interest. We consider this to be one of the key lessons of the financial crisis. We agree that the documentation of roles and of any conflicts of interest will be helpful in dealing with conflict issues.

However, we are concerned that documentation alone will be insufficient to ensure that conflicts are adequately managed. We would therefore place particular importance on the second part of best practice guideline 3: "a plan to manage those conflicts where appropriate."

We would propose the deletion of the words 'where appropriate', since we cannot imagine a circumstance in which it was inappropriate to take action to manage conflicts of interest. We are also concerned that this wording is somewhat ambiguous and could be taken to imply that documentation itself is optional. It seems uncontroversial to suggest that the documentation of conflicts of interest is now appropriate in all circumstances, and the guidance should make this clear.

Question 2 [also relevant to Question 7(c)]

Here we wish to comment briefly on the proposed wording of the first guideline to Principle 2. The corresponding Myners Principle guidance stresses the importance of trustees having "*sufficient*

expertise to be able to evaluate and challenge the advice they receive, and manage conflicts of interest.”

However, this is not mentioned in the proposed new guideline, which simply says they should *“have or acquire the relevant knowledge, understanding and skills to take decisions, which may be based on advice from those reasonably expected to have the necessary expertise.”*

We are concerned by the implication that, in contradiction to the Myners Principles, it is sufficient for trustees to rely on expert advice when making decisions on behalf of scheme members. Again, we consider it a key lesson of the financial crisis that decision-makers must have the necessary independence and expertise to challenge such advice. We would therefore propose that the original wording of the Myners Principles remains appropriate in this case.

Question 6

We welcome proposed Principle 6. The availability of clear information to scheme members is a vital part of good governance. We feel that the clarity and specificity given by the best practice guidance as to particular information that should be provided is helpful.

We would suggest that, as well as providing investment governance information through the Statement of Investment Principles or through detailing the investment strategy, schemes should report to members on the *implementation* of the SIP/strategy, including the implementation of any policies on engagement.

We remain at your disposal and would welcome the opportunity to meet with you to discuss any or all of the above.

Yours sincerely,

Catherine Howarth
Chief Executive, FairPensions