

**Report of the
Collective Engagement Working Group
December 2013**



Published by the IMA on behalf of the Collective Engagement Working Group.

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December 2013

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Foreword by the Chairman

As a member of Professor Kay's Advisory Board for his review of the effectiveness of the UK equity markets, I recognised the importance of building trust and confidence in the UK equity investment chain. I was, therefore, delighted to be invited to chair the Collective Engagement Working Group which was to take forward one of Professor Kay's recommendations to identify how investors can work together better in engaging with companies, fostering trust and building constructive relationships.

This report of the Working Group is a concerted and enthusiastic response by asset managers and asset owners to the Kay Review's recommendations. We have spent much of the last seven months consulting widely and reflecting deeply amongst ourselves.

Our task was to identify how investors might be able to work together in their engagement with listed companies to improve sustainable, long-term company performance and – crucially – to the benefit of end savers. Our recommendations follow in the main body of this report but we thought it worthwhile to highlight some of the issues that have been debated and the perspectives we discussed. Although our individual views have been healthily varied in their emphasis there is a surprising unanimity in our broad conclusions.

We are all aware that much has gone awry amongst some of our largest companies in recent years. There is no shortage of actors and accidents to hold accountable for the damage this has led to in the broader economy. But asset managers and asset owners must bear their share of responsibility as the principal partners of corporate Britain. Short-term and relative performance pressures frequently impede the fulfillment of the ownership responsibilities delegated to asset managers. Not all institutional investors have the knowledge, guidance or resources to demand better or to do the job themselves. These problems are more central in the United Kingdom than in countries with greater family and founder influence on the corporate sector.

But we insist that improvements in the collective engagement process are not a chimera. They are feasible with consistent and long-lasting effort. Ultimately they can contribute to increased wealth creation by companies and for savers. But this will

require patience rather than sudden and seemingly dramatic gestures.

Our meetings confirmed that there has already been some improvement. As detailed later we are encouraged by the general direction of change and by specific efforts to work together that we wish to support rather than replace. The Association of British Insurers (ABI) and the Local Authority Pension Fund Forum (LAPFF) have led the way. Many individual asset managers and asset owners have improved the seriousness of their stewardship efforts though others have principally ticked boxes. The efforts of Chairmen and Senior Independent Directors have made it far more likely that external voices are heard in the Boardroom than had previously been the case.

Yet we believe that the investment community can – and must – do more. It is inadequate for collective engagement to be so heavily driven by local players. Most British companies are now majority owned by overseas owners. This is unlikely to reverse. Moreover these owners are often of very high calibre ranging from the finest and most expert international investors to the increasingly influential and sophisticated Sovereign Wealth Funds. We are proud that our Group has formally and informally made major steps towards incorporating their skills, concerns and perspectives.

Furthermore, the Group is unanimously and firmly of the view that beyond our formal recommendations, the greatest need is for deep cultural change. As asset managers and asset owners we wish to co-operate in search of greater wealth creation over the long-term. In order to accomplish this, companies must be confident that asset managers and owners prefer to be supportive rather than critical. We must be consistently engaged rather than occasionally outraged.

But we believe that the voice of a committed and constructive investment industry eventually ought to warrant considerable respect. We do not think that investors have the ability to manage companies but we do believe that there are many institutional investors who wish to contribute to good engagement and have the resources, expertise and even far-sightedness to help in the sustainable creation of wealth. We regard it as critically important that the voice of serious and trusted long-term investors should be elevated relative

to the noisy speculators, overly influential investment banks and media babble that have dominated the perception of the City. As Professor Kay says we need to restore trust. This is the background to all our recommendations.

On a final note, this report would not have been possible without the support of the ABI, the Investment Management Association (IMA) and the National Association of Pension Funds (NAPF). We would like to thank the devoted project team of Daniel Godfrey and Liz Murrall at the IMA, Andrew Ninian at the ABI, and David Paterson and Will Pomroy at the NAPF. We would also like to extend special thanks to Jonathan Baird of Freshfields Bruckhaus Deringer, who provided invaluable advice.

A handwritten signature in black ink, appearing to read 'James Anderson'.

James Anderson

Chair Collective Engagement Working Group

3 December 2013

1. Summary

The Collective Engagement Working Group was formed in April 2013 with the objective of identifying how asset managers and asset owners, i.e. institutional investors, might be able to work collectively in their engagement with listed companies to improve sustainable, long-term company performance and overall returns to end savers.

Our terms of reference are set out in Appendix I and our members in Appendix II.

As a Group we concluded that much of what is needed is about how the effectiveness of co-operation can be enhanced so that it focuses more on the long-term strategy of companies and the creation of sustainable value, as opposed to simply establishing new structures. Moreover, whilst today there are already highly effective mechanisms for collective engagement, the ownership of British companies is becoming more and more geographically diverse, such that it is important that when there is an issue with a particular company, international investors are involved to ensure a critical mass of shareholders engage on the matter. It is in this context that this report sets out our findings, thought processes and recommendations.

The Group concluded that an Investor Forum should be established and that it should be operational by the end of June 2014. Our recommendations are summarised below.

Changing the culture around engagement

1. There is a need for cultural change when institutional investors act collectively. Their overarching objective should be to build trust amongst each other, and promote a culture of long-term strategic vision and wealth creation over time. They should elevate engagement to focus on wider outcomes and work together to develop constructive relationships with companies with the aim of securing superior long-term returns. This should be the main objective of our new Forum.

Increasing participation through the Forum

2. The Forum should facilitate collaboration among a wider range of investors, both from the UK and internationally, so as to ensure a critical mass of shareholders is able to contribute to the dialogue. Participation should be voluntary and open to all major institutional investors that have an interest in a company and focus on major UK listed companies.

3. The Forum should be complementary to existing individual and collective engagement mechanisms and be a point of contact when these are not sufficient. Moreover, Forum participants should be able to take a more holistic view when a particular company has issues that could have wider systemic implications, which could impact long-term returns over and above those related to the company in question.
4. The Forum should provide the structure to facilitate and address any mechanical and legal issues that could impact collective engagement. It should be directly governed by asset managers and asset owners themselves. The Working Group is establishing an Implementation Team to determine the Forum's infrastructure, governance and secretariat (a skeleton secretariat is proposed), and to ensure the Forum becomes fully operational. Initial funding to set up the Forum has been underwritten for two years by investors and trade associations, and it will be for the Forum's governance body to establish a sustainable funding structure for its operation in the long-term.
5. The Forum's secretariat should be the main point of contact for institutional investors with concerns and would determine whether there is sufficient support to form an Engagement Action Group in relation to a particular company and issue. It would be the responsibility of the Engagement Action Group to prepare and carry out plans for further engagement with the company. It would be disbanded on resolution of the issues raised. Not every Forum participant would need to be involved with each Engagement Action Group.
6. To the extent that Forum participants reach agreement on specific matters or in relation to a specific Engagement Action Group, the secretariat should consider whether and how this should be disseminated. The Implementation Team should deliberate on ways the Forum could promote awareness of collective engagement to a wider audience.
7. Routine remuneration matters should not be a core focus for the Forum, but where questionable remuneration policies are a symptom of broader issues such that they become more of a strategic question, then they should form part of the Forum's wider focus.

Companies holding an annual strategy meeting

8. Companies should have an annual strategy meeting or equivalent with institutional investors (or explain why not). To ensure consistent messaging third parties such as brokers and analysts should not be invited. The Forum would help companies on the details of such meetings. More effective use could also be made of the principal conclusions of board evaluations, which should be shared with investors as part of this meeting.

Improving accountability in the investment chain

9. Institutional investors should look at their own practices and cultures, and ensure that the right people are part of the engagement and that engagement on governance issues is integrated into the investment process. They should also monitor closely and disclose potential conflicts of interest.
10. Asset owners should be clear when appointing an asset manager to ensure the manager's approach to stewardship is aligned with their interests and that there is a strategy for, or policy on, engagement. In evaluating an asset manager, asset owners should examine how the manager has engaged with companies in the interests of protecting and enhancing value in the future and assess performance over an appropriately long-term time-frame. This should also apply to investment consultants.
11. Institutional investors should ask for feedback from company Non-Executive Directors on the quality of their engagement.

Addressing the potential impediments

12. The secretariat, with access to legal advice, should provide an additional layer of protection to Forum participants over and above the Takeover Panel's very helpful Practice Statement No. 26, Shareholder Activism. This would mean seeking regular information from all participants in an Engagement Action Group such that they do not inadvertently cause a concert party to be formed. The secretariat should create a questionnaire for use with Engagement Action Group participants in this

regard. The secretariat should approach the Panel for guidance or a ruling if there is any doubt over a proposed action.

13. The precise terms on which the Forum proposes to deal with inside information and the applicability of the market abuse regime should be discussed with the Financial Conduct Authority (FCA) in advance to ensure that any concerns that may be raised by the FCA are adequately addressed. Again, it is important that the Forum's secretariat has ongoing access to a legal advisor given the complexity of the requirements over inside information. Participants should be able to record support in advance of the establishment of an Engagement Action Group, without being required to participate further or even to know whether a Group has been established.
14. The Forum should have a Participant Undertaking, adherence to which would be a condition of taking part in any collective engagement. The Undertaking would include a strict confidentiality obligation as well as requirements not to: (i) disclose confidential or price sensitive information to other investors taking part without their express consent; or (ii) use such information received as a consequence of participation in the Forum's activities.

Measuring the Forum's success

15. The key measure of the Forum's success would be if it achieved cultural change over time such that companies and institutional investors instinctively work together constructively to ensure sustainable wealth creation. In the near-term, more tangible measures of success should be developed, for example: major companies holding an annual strategy meeting, or equivalent, which is regularly attended by institutional investors; increased participation from overseas investors and from investors that did not engage in the past; and companies seeing engagement as something that is constructive.

Next steps

16. The Implementation Team will provide a status update by the end of March 2014.

2. Introduction

In 2011, the Secretary of State for Business, Innovation and Skills invited Professor John Kay to review activity in UK equity markets, and its impact on the long-term performance and governance of UK quoted companies. Professor Kay's final report¹ concluded that the key problem is the systemic short-termism mainly caused by a decline in trust and confidence and the misalignment of incentives throughout the UK equity investment chain. The UK equity markets had become increasingly fragmented, with ever more intermediation.

One of the recommendations in his report to address this was that: "an investors' forum should be established to facilitate collective engagement by investors in UK companies²".

On the day the Government published its response to the Review³, the IMA announced its plans to seek to facilitate collective action. It followed this up during the first part of 2013 with meetings with a range of over 60 investor representatives and some investee companies, inviting the ABI and NAPF to these meetings.

Whilst there are already channels for collective engagement that work well, many suggestions were received on what more could be done, how this could work, as well as the likely impediments to its successful operation. The question, therefore, remained as to whether collective engagement could be made more effective. Thus the three trade associations that represent the majority of UK institutional investors, the IMA, the ABI and the NAPF, agreed to establish the Collective Engagement Working Group with the objective of identifying how investors might be able to extend their ability and effectiveness to work together in their engagement with companies.

The members of the Working Group were drawn from insurance companies, asset managers, pension funds and other institutional investors, including overseas investors, who for a variety of reasons are often not part of the dialogue, although they own an increasing proportion of the UK stock market.

This report is the final product of our work and sets out a number of recommendations to help enhance investors' engagement and collective dialogue with companies. A considerable team effort has gone into the production of this report. We met with many experienced and engaged individuals, and groups to discuss the issues in detail, through which we obtained constructive and thoughtful input. This included overseas, Sovereign Wealth Fund and hedge fund investors, as well as companies. In these meetings, we aimed to discuss what could or would work and what, if any, issues need to be addressed. These meetings helped us develop our thinking and recommendations, and we are indebted to those who committed their time. We hope many will see the points they raised reflected in this report.

We summarise the issues we identified, details of our discussions with others and our recommendations in Section 3 below.

¹ <http://www.bis.gov.uk/assets/biscore/business-law/docs/k/12-917-kay-review-of-equity-markets-final-report.pdf>

² Page 51

³ <http://www.bis.gov.uk/assets/biscore/business-law/docs/e/12-1188-equity-markets-support-growth-response-to-kay-review>

3. Issues identified and recommendations

Changing the culture around engagement

Professor Kay's final report identified the culture of short-termism due to a lack of trust as one of the key obstacles to the equity markets sustaining high performing British companies that generate returns to end savers. One of his recommendations to address this was that an investor forum should be established to facilitate investors coming together to engage collectively.

Our Working Group recognised that if we want British companies to deliver superior long-term returns it is important that institutional investors, as their owners, develop constructive relationships with them and work to assist them to do so. In particular, in recent years we have learnt that mutual understanding between institutional investors and companies could benefit from more cohesion, particularly around long-term objectives and strategy. There is no one "silver bullet" available for the realisation of this goal. However, our key objective is to achieve a cultural shift in the priorities of the engagement between institutional investors and companies.

A number of the listed companies we met with emphasised the importance of this. They stressed that both investors and companies need to take a broader perspective and focus more on the long-term. We agreed that enduring relationships based on trust and respect can only develop if engagement is seen to be constructive, and is not only when things have gone wrong.

Thus the new Forum we propose would primarily be a place where investors come together and work collectively to promote a long-term culture with wealth creation and sustainability at its core. It should be strategic in its focus. One of the indicators of success would be if eventually there is less need for collective engagement, less noise about dismissing directors, less focus on short-term quantitative targets, and less involvement in the detail of executive remuneration. Through institutional investors working with company management, British companies should be better able to deliver sustainable wealth, which translates into better returns for savers. We would welcome companies buying into this and working with us to achieve this aim.

Recommendation

There is a need for cultural change when institutional investors act collectively. Their overarching objective should be to build trust amongst each other, and promote a culture of long-term strategic vision and wealth creation over time. They should elevate engagement to focus on wider outcomes and work together to develop constructive relationships with companies with the aim of securing superior long-term returns. This should be the main objective of our new Forum.

Increasing participation through the Forum

Participation

As a Group we appreciated that over the last ten years there has been much progress around institutional investors' stewardship of British companies. There are currently numerous, highly effective, one to one engagements. Also, when there are shared concerns, UK institutional investors come together to engage in various ways. In the first instance they contact colleagues in other firms to compare notes on a certain company or situation. There are also established groups where they meet to discuss issues relating to particular companies and to interact with the companies concerned. The UK's Corporate Governance Forum, the LAPFF and the meetings run by the various trade associations are examples of such groups.

We are also encouraged by the way these groups have been developing over time. We support, for example, the ABI Executive's recent review of its existing engagement process by:

- Expanding it so that all significant shareholders are invited to participate in meetings whether or not they are ABI members.
- Establishing an "Investor Exchange" to enable any significant shareholder to raise a concern on a particular UK-listed Company with other shareholders in a pro-active way.

These existing mechanisms have an important part to play and we endorse their continuing role. However, one of Professor Kay's objectives in recommending the establishment of an investor forum was to increase the involvement of overseas investors, for example, Sovereign Wealth Funds. This is particularly important given that the main British companies tend to have a geographically diverse shareholder base. The members of the three associations that support our work, the ABI, IMA and NAPF, represent the bulk of UK institutional investors, and yet an increasing proportion of the UK stock market is held by overseas investors⁴.

This was highlighted during our meetings, in that many investors can find it difficult to influence major companies due to the fragmented nature of the share register. The same is not true for smaller companies where an institutional shareholder is more likely to have a larger interest in the company. If such a shareholder makes its views known, it is more likely to influence the company concerned.

We met with a number overseas institutional investors and welcomed their willingness to support our initiative. And whilst there are already a number of highly effective collective groups, investors, particularly those from overseas, expressed concerns:

- Very often these established groups focus on UK shareholders and are not necessarily accessible to a company's international shareholders.
- Commercial considerations, for example, issues around confidentiality and conflicts of interest, may inhibit contact in some circumstances.
- There are the issues concerning inside information and some investors consider that contact with others may risk falling foul of concert party rules and/or the controllers' regime.

We felt that these points needed to be addressed. Our new Forum will seek to introduce the cultural changes that are needed. But in addition to this the Forum should be able to bring together a wider range of investors, both from the UK and internationally, so as to ensure a critical mass of shareholders is convened and engages on issues at companies where existing mechanisms have failed. Consequently, we agreed that

participation in the Forum should be voluntary and open to all institutions with an interest in a UK listed company where there is an issue, including UK asset managers, asset owners and international investors. A specialist agency could help identify a company's shareholders. The premises underlying this recommendation were:

- Informed shareholder engagement can help promote long-term, sustainable shareholder value.
- Collective engagement is complementary to, not a replacement for, individual engagement.
- Collective action could deliver better outcomes where existing and individual collective engagement mechanisms are failing.

Moreover, we also recognised that it may be important for the Forum to take a more holistic view when there are issues with a particular company that could have wider systemic implications which could impact long-term returns over and above those related to the stock in question. But we did not consider that the Forum should address general policy issues. These should continue to be dealt with by the individual trade associations – ABI, IMA and NAPF – within each association's established governance framework. We welcome evidence that they are already working more closely together on such matters.

Recommendations

The Forum should facilitate collaboration among a wider range of investors, both from the UK and internationally, so as to ensure a critical mass of shareholders is able to contribute to the dialogue. Participation should be voluntary and open to all major institutional investors that have an interest in a company and focus on major UK listed companies.

The Forum should be complementary to existing individual and collective engagement mechanisms and be a point of contact when these are not sufficient. Moreover, Forum participants should be able to take a more holistic view when a particular company has issues that could have wider systemic implications which could impact long-term returns over and above those related to the company in question.

⁴ According to the Office of National Statistics as at the end of 2012 overseas investors held 53.2% of the value of the UK market, up from 30.7 % in 1998 and 43.4% in 2010.

Structure and modus operandi

The Group considered it important that the Forum should provide the necessary structure to facilitate, and address any mechanical and legal issues that could impact collective engagement. It would act as a central point of contact and facilitate communication among participants. To undertake these roles, it would need a certain amount of resource and a skeleton secretariat. In concept, the secretariat would provide help and support to Forum participants, and convene meetings. These meetings could be face-to-face, by telephone or by other means of communication, e.g. the internet.

One type of meeting could be to discuss general issues that elevate engagement with companies, or to address matters of common interest. It would be agreed in advance that specific information regarding particular companies could not be discussed without the consent of all participants present.

A second type of meeting could aim to bring together a wider range of investors, when existing individual and collective engagements have not been satisfactory, to form an Engagement Action Group to take the matter forward with the company concerned – this is discussed below.

In light of the likely ad hoc nature of the Forum's work, the secretariat need not necessarily be full-time. However, given the sensitivities involved it is likely to need someone sufficiently senior to give leadership and to help ensure that participants in the process are able to develop a common approach. The secretariat would also perform a compliance role for the Forum, as described in the section on addressing the potential impediments below. Thus the secretariat may initially have two members acting on a part-time basis:

- A senior representative of the asset management community to act as convenor and moderator.
- A senior advisor who is experienced in dealing with the legal and compliance issues surrounding the work of the Forum.

We believed that institutional investors themselves should control the Forum i.e. the asset managers and asset owners, and not trade associations. But it is equally important that the Forum has an infrastructure to provide oversight and guard against mission creep in

its role and brief. Regarding this point, there was general consensus that oversight should be provided by a form of board. This board would be likely to consist of a core group of committed, long-term institutional investors, with significant representation from asset owners.

The involvement of a secretariat means that funding will be required. Initial funding to set up and administer the Forum for two years has been secured and underwritten by investors and trade associations. However, we concluded that the Forum would need to determine a sustainable self-financing structure. One of the roles of the Forum's governance body would be to determine a sustainable funding structure for the Forum's operation in the long-term.

A diagram of the Forum's proposed structure is set out in Appendix III.

The Working Group is establishing an Implementation Team to conduct the necessary work to determine the Forum's governance and oversight arrangements, and the optimum infrastructure, including identifying the individuals who could perform the necessary functions. The Implementation Team's overarching objective will be to provide a status update by the end of March 2014 and take such steps as deemed necessary so that the Forum is fully operational by the end of June 2014.

Recommendation

The Forum should provide the structure to facilitate and address any mechanical and legal issues that could impact collective engagement. It should be directly governed by asset managers and asset owners themselves. The Working Group is establishing an Implementation Team to determine the Forum's infrastructure, governance and secretariat (a skeleton secretariat is proposed), and to ensure the Forum becomes fully operational. Initial funding to set up the Forum has been underwritten for two years by investors and trade associations, and it will be for the Forum's governance body to establish a sustainable funding structure for its operation in the long-term.

Engagement Action Groups

As noted above, one of the Forum's roles would be to bring together a wider range of institutional investors when existing individual and collective engagements have not been satisfactory. In such instances, the Forum would be activated by investors contacting the secretariat. The secretariat would establish how widely concerns are shared and assess whether there is a critical mass of support for a collective engagement process. There may be a secure electronic process for exchanging views. If concerns are not widely shared so that there is insufficient support to proceed to a further stage, the issue might be kept on a "watch list" or similar until there is critical mass.

Importantly, the secretariat could develop into a point of contact for companies seeking the views of investors.

The secretariat would bear the load of the work and determine objectively whether sufficient support for further action exists to support the formation of an Engagement Action Group. All institutional investors who are identified as having an interest in the company in question would receive notice of the relevant Engagement Action Group meeting. Investors would be able to register an interest in engaging on specific issues and/or any particular company. Not all those who had been contacted would need to be involved in all of the Forum's discussions. Indeed, some may specifically decide not to be involved in certain discussions. Moreover, a Forum participant would not necessarily have to join an Engagement Action Group.

We considered that a relatively small number of investors, up to ten, would be optimal for the success of any Engagement Action Group. However, whilst it is likely that priority would be given to the largest shareholders, others, even with no holding in the company should be able to give input to the Group where it is helpful.

An Engagement Action Group relating to a specific company would be led by one or more investors in that company, with the assistance of the secretariat, and with other Forum participants deciding on whether they

wish to join (or continue to join) in any given discussions.

The objective of an Engagement Action Group would be to secure agreement on objectives and future plans that would probably start with a letter to the Chairman. One company we met with advised us that a letter sent on behalf of a number of shareholders would be certain to receive a Board's full attention.

Companies also told us of the importance of planning the ground for any collective engagement in advance. Thus the secretariat would prepare an agenda for any meetings which would be agreed with the Engagement Action Group and then with the company, if they are to meet together. It would also ensure the Group is backed by informed research. Once the issue has been resolved the Group would be disbanded.

Although we recognised there may be instances when the Forum wishes to make its concerns about a company public, these are likely to be rare, and "behind the scenes" work is likely to be a more frequent modus operandi.

It is envisaged that the experiences of early Engagement Action Groups would be part of a learning process during which the most effective structures and methods would be identified and used to enhance Forum procedures.

Recommendation

The Forum's secretariat should be the main point of contact for institutional investors with concerns and would determine whether there is sufficient support to form an Engagement Action Group in relation to a particular company and issue. It would be the responsibility of the Engagement Action Group to prepare and carry out plans for further engagement with the company. It would be disbanded on resolution of the issues raised. Not every Forum participant would need to be involved with each Engagement Action Group.

Communication

Our Group recognised that communication around engagement needs to improve. Thus to the extent that Forum participants reach agreement on specific matters or in relation to a specific Engagement Action Group, we agreed we may want the secretariat to disseminate their views. This could take a number of different forms, depending on the matter in question. For example, matters of general relevance to companies and investors may be published in a general or press release, whereas matters specific to a particular company may be communicated privately by the secretariat to that company or by a meeting between the company and representatives of the Engagement Action Group.

In addition, one of our aims, as set out in the Terms of Reference, is to increase the understanding of collective engagement. Thus over time the Forum could look to issue a report on its activities, anonymised as appropriate.

Recommendation

To the extent that Forum participants reach agreement on specific matters or in relation to a specific Engagement Action Group, the secretariat should consider whether and how this should be disseminated. The Implementation Team should deliberate on ways the Forum could promote awareness of collective engagement to a wider audience.

Remuneration

No recommendations on engagement would be complete without a reference to executive remuneration. We heard from companies of the difficulties caused by the lack of a consistent view amongst investors on best practice for remuneration policies. They felt investors were often 'strident' on this matter, and were increasingly concerned about the amount of time and resource it takes up, believing it will become more difficult to find people to chair remuneration committees. Moreover, they often receive contradictory messages on governance and remuneration issues. Investors are also often frustrated with the amount of consultation and the time they are being asked to devote to the issue by companies. Engagement on remuneration issues is also much improved when it is considered in conjunction with a company's strategy.

Despite many of our Group being sceptical about some of the levels of remuneration and the underlying metrics that seek to justify them, we did not consider that routine remuneration issues should necessarily be a priority for the Forum. They are not the key driver of long-term company performance and wealth creation nor are the best company executives motivated by rewards and short-term targets. Companies should also be confident that they can make their own decisions and not always consult investors on every minor policy change. However, where questionable remuneration policies are a symptom of wider issues such that they become more of a strategic matter, then the Forum should focus on them.

Recommendation

Routine remuneration matters should not be a core focus for the Forum, but where questionable remuneration policies are a symptom of broader issues such that they become more of a strategic question, then they should form part of the Forum's wider focus.

Companies holding an annual strategy meeting

As noted above, our aim in establishing a Forum is to improve sustainable, long-term company performance. Thus we considered it important that companies have and take the opportunity to articulate their strategy on how they plan to achieve this and communicate it to investors.

We understood from companies that they often discuss changes in strategy with their largest investors. A number of companies stated that they would welcome a collective investor meeting specifically on strategy with the proviso that the conversation is two-way and such meetings have clear procedures. In this context, some companies have already contemplated holding such meetings and others already do, for example Dunelm, Marks & Spencer⁵, BP, HSBC, and Rio Tinto's "Corporate governance round table" which is linked to its strategy⁶. Companies value these meetings.

We agreed that major listed companies should have an annual strategy meeting with institutional investors. The meeting should aim to inform investors and be an opportunity for investors to influence the company concerned. The meeting might involve the Chairman and other directors, together with long-term institutional investors. In the interests of ensuring the dialogue is between companies and their investors and that messaging is kept consistent, brokers and their analysts should not be invited. The presentations should be made public. The Forum will help companies on the details of setting up the annual strategy meeting.

We also felt that due to its importance the meeting should be held during the business day. It should not be part of the Annual General Meeting (AGM); in that whilst the AGM is important, it could be usefully supplemented by a meeting more suited to the stewardship role of long-term institutional investors.

We also heard from companies how the processes for reviewing a board's effectiveness are developing in terms of the quality of evaluators and the participation by Directors. They appreciate an external, independent evaluator and it is important that there is trust between

the Board and the evaluators as sometimes the latter have a sensitive message for the Chairman or Senior Independent Director. We considered that in order to make this more transparent for investors, the principal conclusions of any evaluation should be discussed with them.

Recommendation

Companies should have an annual strategy meeting or equivalent with institutional investors (or explain why not). To ensure consistent messaging third parties such as brokers and analysts should not be invited. The Forum would help companies on the details of such meetings. More effective use could also be made of the principal conclusions of board evaluations, which should be shared with investors as part of this meeting.

Improving accountability in the investment chain

As the ultimate clients, we believe it is vital that asset owners drive engagement by encouraging their appointed asset managers to engage and act collectively if necessary. Whilst many asset owners require their asset managers to have a strategy for or policy on engagement, some may do so in a form that encourages box-ticking and others may not provide sufficient guidance or direction to drive their asset managers to constructively engage with investee companies. It is important that asset owners clearly specify their requirements for stewardship when appointing asset managers to ensure their managers are aligned with their interests, and that the dialogue between the two improves. In this context, the NAPF recently issued its Stewardship Disclosure Framework⁷ to help asset owners understand the approach to engagement of current and prospective asset managers in order that they can select those who most appropriately meet their own expectations.

In this context, asset owners are often guided by consultants that look at a manager's people, processes and performance. It can be difficult to assess the first two and with the latter, there can often be too much

⁵ http://corporate.marksandspencer.com/documents/results_presentations/2013/governanceevent2013.pdf

⁶ http://www.riotinto.com/documents/Corporate_governance_round_table_27_Feb_2012.pdf

⁷ <http://www.napf.co.uk/PolicyandResearch/Corporate-Governance/Stewardship/Stewardship-disclosure-framework.aspx>

focus on short-term performance. We consider it important that asset owners take more of a long-term holistic view when reviewing an asset manager’s performance to evaluate their record, attitude and current capabilities on engagement. This should also apply to investment consultants when they evaluate asset managers.

Companies also commented that they can receive mixed messages from institutional investors. They observed that the individuals who make governance decisions within asset managers are not always integrated with the portfolio managers responsible for buying and selling the shares.

We considered it important that these matters are addressed and that institutional investors look at their own practices and cultures, and ensure that, where it is not already, engagement on governance issues is integrated into the investment process.

Proxy voting agencies can exacerbate the problems around mixed messages. We consider proxy voting is an essential part of the investment process but it is important that an institutional investor evaluates each substantive voting decision in the context of its own research and investment process without undue reliance on the recommendations of proxy voting agencies.

Companies observed that investors rarely ask for feedback from a company’s Non-Executive Directors on their own engagement practices. They felt that if investors were to receive feedback it could improve the quality of engagement but they need to be clear about who should receive it.

Recommendations

Institutional investors should look at their own practices and cultures, and ensure that the right people are part of the engagement and that engagement on governance issues is integrated into the investment process. They should also monitor closely and disclose potential conflicts of interest.

Asset owners should be clear when appointing an asset manager to ensure the manager’s approach to stewardship is aligned with their interests and there is a strategy for, or policy on, engagement.

In evaluating an asset manager, asset owners should examine how the manager has engaged with companies in the interests of protecting and enhancing value in the future and assess performance over an appropriately long-term time-frame. This should also apply to investment consultants.

Institutional investors should ask for feedback from company Non-Executive Directors on the quality of their engagement.

Addressing the potential impediments

During the course of our work we recognised that the operation of the Forum will present a number of legal and regulatory concerns, which potential participants (and companies which are the subject of discussion by the Forum) will need to be satisfied are being effectively addressed. We appreciated that the Forum must not be intended as, and could not be operated as, a means of avoiding or evading applicable law and regulation.

We identified four main potential impediments: acting in concert; market abuse/insider trading; confidentiality; and anti-trust laws. These impediments are discussed here and the requirements on acting in concert and insider trading are set out in more detail in Appendix IV.

Besides protecting the interests of participants in the Forum, we considered it important that each of the above concerns is dealt with, and seen to be dealt with, in as robust a way as possible in order to: (i) prevent companies from being able to use any or all of these concerns as a device to prevent the proper functioning of the Forum; and (ii) remove perceived impediments to participation on the part of investors. Moreover, given the complexity of these areas, we considered it would be helpful for the Forum to have access to a legal advisor on an ongoing basis. The latter could oversee and highlight discussions where price sensitive information is likely to be raised, or, less likely, where there may be issues over “acting in concert”.

Acting in concert

On acting in concert, the Takeover Panel's ("the Panel") Code requires that if investors act collectively such that the combined ownership of the parties "acting in concert" exceeds 30% **and** they seek to obtain control of the board of the company, they may have to make a mandatory bid for the company if they acquire further interests in its shares. It is understood that the parties involved are jointly and severally liable – each could be left with the responsibility to make a full bid – although the prime responsibility for making an offer will normally attach to the person who acquires the interest which results in the obligation to make the mandatory bid.

In September 2009, the Panel issued Practice Statement No. 26 which describes the Panel Executive's interpretation of how it applies the relevant provisions of the Code (namely Note 2 on Rule 9.1). The Practice Statement⁸ is very helpful and clarifies that the risk that collective action would trigger a mandatory offer requirement is negligible. In summary, it could only be triggered if **ALL** of the following are satisfied:

- Shareholders **propose or threaten a "board control-seeking" resolution** to replace directors. In determining whether a proposal is "board-control seeking", the Panel will have regard to a number of factors, including whether:
 - The **proposed directors have "a significant relationship" with the shareholders such that they are not independent**, e.g. if there has been a previous relationship (employees, directors or officers of the shareholders), there are agreements, arrangements or understandings in place, or the directors are to be remunerated by the shareholders; and
 - The **proposed directors would control the board**, i.e. replacing only the CEO or two or more NEDs would not normally be considered "board control-seeking".
- Then one or more of the shareholders concerned must acquire interests in shares such that the shares in which they are interested together carry 30% of the voting rights or, if they already hold shares with 30% or more of the voting rights, they acquire any further shares.

Whilst the Practice Statement clarifies matters, we still had concerns that investors may feel that they must raise the spectre of requisitioning a general meeting to change the board as a means of expressing their deep concerns over a company's unwillingness to address an issue. Also, those within a collective group may not be clear as to all the other participants' relationships with the proposed directors. Thus a "significant relationship" may exist between a director and another participant of which other group members are unaware. There are no "bright lines" on the issue in that the Panel retains discretion and looks at each situation on a case-by-case basis.

The proposed structure and processes of the Forum have been discussed with the Panel so that it understands the mechanics of the Forum and role of the secretariat. In very constructive discussions, the Panel made it clear that the prospect of a participant in a collective Engagement Action Group being required to make a mandatory offer was negligible. The Panel pointed out that there had not been a single instance of the Panel requiring a mandatory offer to be made in the context of a "board control-seeking" resolution since the introduction of Note 2 on Rule 9.1 in 2002.

The Panel also made it clear that, assuming that the secretariat to the Forum was appropriately authorised by the Engagement Action Group's participants, it would view the secretariat as having a locus to approach the Panel to discuss the details of any proposed action and the parties involved in order to seek guidance or a ruling as to whether a particular proposal would be considered to be "board control-seeking". The secretariat could develop a questionnaire to elicit all the relevant information from Engagement Action Group participants ahead of such discussions. This involvement of the secretariat has the additional benefit for investors that the secretariat will, over time, become a repository of experience and knowledge on which all participants can draw.

We, therefore, felt that it should be one of the roles of the secretariat and its legal advisor to manage the affairs of each Engagement Action Group so that they do not inadvertently become a concern under the Takeover Code (including "board-seeking control" resolutions as described in the Code).

⁸ <http://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/11/ps26.pdf>

Recommendation

The secretariat, with access to legal advice, should provide an additional layer of protection to Forum participants over and above the Takeover Panel's very helpful Practice Statement No. 26, Shareholder Activism. This would mean seeking regular information from all participants in an Engagement Action Group such that they do not inadvertently cause a concert party to be formed. The secretariat should create a questionnaire for use with Engagement Action Group participants in this regard. The secretariat should approach the Panel for guidance or a ruling if there is any doubt over a proposed action.

Inside information and market abuse issues

We considered the issue of inside information and market abuse to be more complicated. For example, during an engagement, information that could have a "significant effect" on a company's share price could be created or received meaning the shares could not be traded by participants for an indefinite period (until there is a public announcement). The insider dealing and market abuse regimes present a number of concerns:

- That the Forum is not a mechanism for the dissemination of confidential or price sensitive information in breach of law or regulation.
- That by taking part in the Forum, participants are not made insiders in relation to particular companies without their specific consent, whether as a result of the receipt of specific information regarding that company or by the decision by Forum participants to take particular action in relation to an issue constituting inside information in itself.

However, to facilitate collective engagement we believe the Forum would need to establish an infrastructure and the secretariat would need to manage the affairs of the Forum so as to deal with price sensitive information.

To maximise the strength of any Engagement Action Group, it is desirable that it should be able to speak for as much of the shareholder base as possible. We have proposed a mechanism to enable the participation of shareholders, who may not wish to be identified or for whom the possibility of being unable to trade the shares of the company concerned is unacceptable.

The proposed mechanism would enable investors to inform the secretariat, under strict confidentiality, their support for a putative Group in a given case and their willingness to vote their shares in its support should such a vote become necessary. In such circumstances, these investors would receive no further information, not even to be told that there was sufficient support to establish an Engagement Action Group.

The merit of such a mechanism would be twofold. First, the investors would ensure that they did not expose themselves to a position under which they might become party to non-public price-sensitive information but would be able to ensure that their holding was adding to the weight of support if an Engagement Action Group was formed. Secondly, the Forum and the Group would be able to begin its collective engagement with the company concerned with a heavier weight of shares strengthening their hand.

Recommendation

The precise terms on which the Forum proposes to deal with inside information and the applicability of the market abuse regime should be discussed with the Financial Conduct Authority (FCA) in advance to ensure that any concerns that may be raised by the FCA are adequately addressed. Again it is important that the Forum's secretariat has ongoing access to a legal advisor given the complexity of the requirements over inside information. Investors should be able to record support in advance of the establishment of an Engagement Action Group, without being required to participate further or even to know whether a Group has been established.

Confidentiality

A common theme throughout our meetings was the importance of building trust between participants in a collective engagement and concerns from companies about matters being leaked to the media. Experience suggests that leaks can never be prevented completely. However, we agreed that to protect both the integrity of the Forum and its participants, all participants would be required to agree to a Participant Undertaking. This Undertaking would require each investor to:

- Acknowledge the rules of the Forum.
- Agree that the Forum must operate in accordance with applicable law and regulation.
- Agree that the Forum must not be used as a mechanism for the dissemination of confidential or price-sensitive information to other participants or third parties.
- Agree not to use any information obtained from the Forum for unlawful purposes or to the detriment of other Forum participants.
- Agree to maintain absolute confidentiality about discussions that have taken place regarding activities and the existence of an Engagement Action Group unless the Group decides to make a public announcement.
- Failure to follow the Undertaking or other rules of the Forum would result in a participant being expelled from the Forum.

Recommendation

The Forum should have a Participant Undertaking, adherence to which would be a condition of taking part in any collective engagement. The Undertaking would include a strict confidentiality obligation as well as requirements not to: (i) disclose confidential or price sensitive information to other investors taking part without their express consent; or (ii) use such information received as a consequence of participation in the Forum's activities.

Anti-trust laws

We were advised that whether the Forum's activities would implicate anti-trust laws would depend on specific cases. We agreed that we would discuss this with the Government in order to obtain as much comfort as possible that the ordinary operation of the Forum would not become the subject of scrutiny by the competition regulators.

Measuring the Forum's success

We considered it important that we measure the success or otherwise of the Forum. We were unanimous in that one of the key measures of success would be if the Forum achieved cultural change over time such that companies and institutional investors work together constructively to ensure sustainable wealth creation. We recognised that this is likely to be a long process and that more tangible and immediate measures may be needed. For example: major companies holding an annual strategy meeting, or equivalent, which is regularly attended by institutional investors; increased participation from overseas investors and from investors that did not engage in the past; and companies seeing engagement as something that is constructive.

Recommendation

The key measure of the Forum's success would be if it achieved cultural change over time such that companies and institutional investors instinctively work together constructively to ensure sustainable wealth creation. In the near-term, more tangible measures of success should be developed, for example: major companies holding an annual strategy meeting, or equivalent, which is regularly attended by institutional investors; increased participation from overseas investors and from investors that did not engage in the past; and companies seeing engagement as something that is constructive.

Terms of reference

The objective of the Working Group is to identify how investors might be able to work together in their engagement with listed companies to improve both sustainable, long-term company performance and the overall returns to end savers.

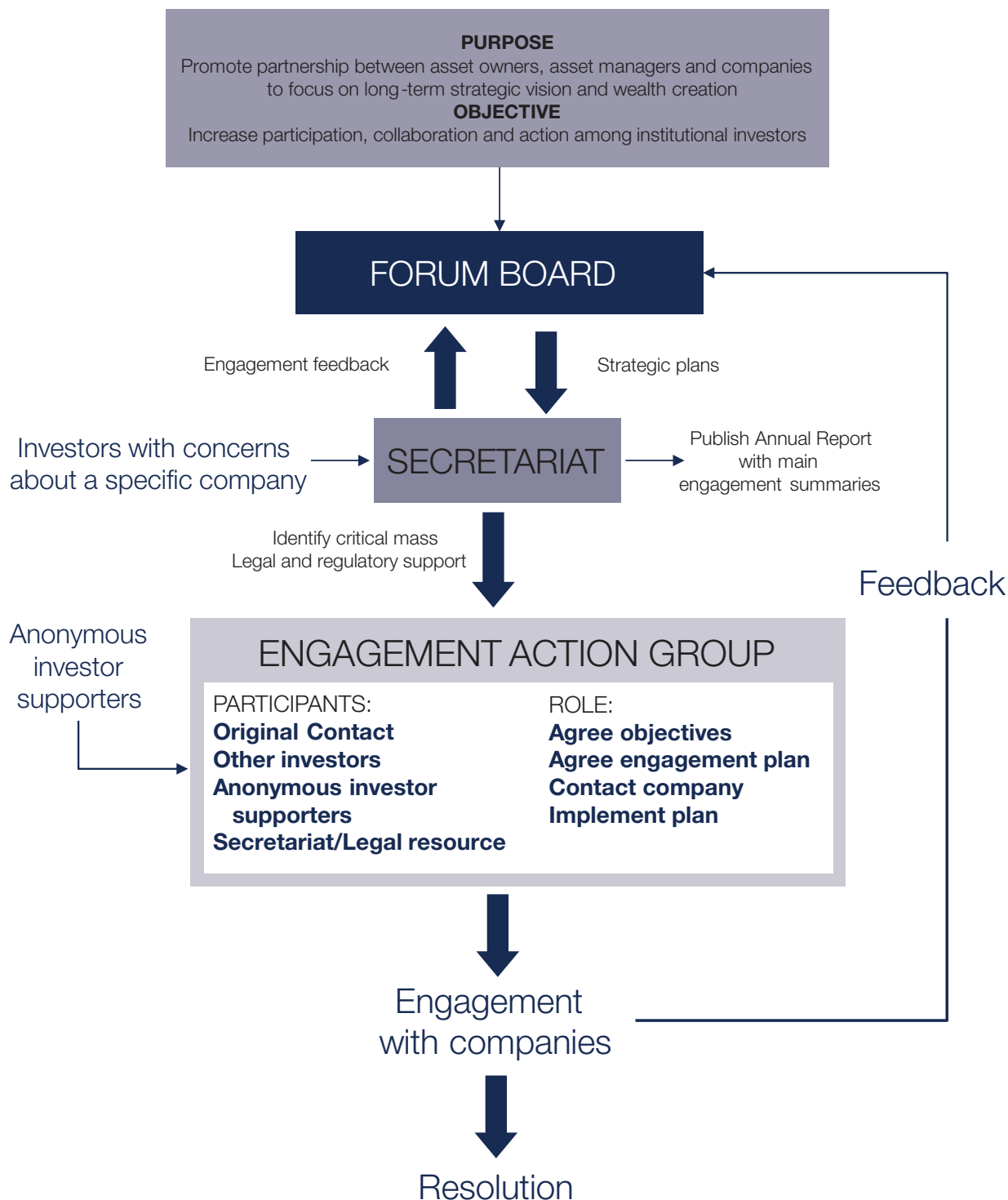
To achieve this objective, the Working Group is asked:

1. To review the ways in which investors act collectively as owners of listed companies, including:
 - Who currently participates and in what form?
 - What are the strengths and weaknesses of the current models?
 - Are there issues (including conflicts of interest) which inhibit effective collaboration?
 - How do investors demonstrate the effectiveness of their engagement?
 - Are governance and investment decision-making teams sufficiently linked?
2. To consider the impediments to effective and frequent collective engagement that exist as a consequence of regulatory or legal obligations and potential remedies that would need to be implemented to overcome them:
 - Market Abuse.
 - Concert Party.
 - Inside information.
 - Confidentiality/leaks.
3. To consider ways in which current activity might be built upon with the objective of:
 - Increasing the effectiveness of collective engagement.
 - Broadening the reach of collective engagement to a wider range of investor types than is currently the case.
 - Increasing the understanding of collective engagement activity.
4. To make recommendations to investors concerning the best ways to structure collective engagement. To also make recommendations to Government and regulators as to any changes that might be required to law, regulation or guidance to afford any new initiatives the greatest chance of success.
5. To report by December 2013.

The members of the Working Group

Chairman	James Anderson	Partner, Baillie Gifford
	Peter Harrison	Global Head of Equities, Schroders
	Claudia Kruse	Managing Director, Governance & Sustainability, APG
	Ida Levine	Director & Senior Legal Counsel, Capital International Limited
	Michelle McGregor-Smith	Chief Executive Officer, British Airways Pensions Investment Management
	Richard McIndoe	Head of Pensions, Strathclyde Pension Fund
	Jeff Molitor	CIO, Vanguard Asset Management
	Sacha Sadan	Director of Corporate Governance, Legal & General Investment Management
	Victoria Sant	Investment Manager, The Wellcome Trust
	Robert Talbut	Chief Investment Officer, Royal London Asset Management

The Forum's proposed structure



Addressing the potential impediments

Acting in concert

Introduction

Shareholders typically have relatively small holdings, particularly in larger companies. This can at times make it difficult for them to be effective on their own and yet there are concerns that should they come together and act collectively, the “concert party” rules could be triggered. The uncertainties arise first, from the mandatory bid rules implementing the Takeover Directive and secondly, from the requirements implementing the Acquisitions Directive.

Takeover Rules

The City Code on Takeovers and Mergers (the Code) has been developed since 1968 to reflect the collective opinion of those involved in takeovers to ensure appropriate business standards are followed and an orderly framework for takeovers is achieved. Following the implementation of the Takeovers Directive by means of Part 28 of the Companies Act 2006, the rules set out in the Code have a statutory basis and comply with the relevant requirements of the Directive. The rules also have a statutory basis in relation to the Isle of Man, Jersey and Guernsey.

The rules require that if a person and someone acting in concert acquire an interest in shares which exceeds 30%, a mandatory offer has to be made for all the shares of the company. The underlying philosophy is that if control of a company passes into the hands of one shareholder, all shareholders should have the chance to dispose of their shares at the highest price paid by the new controller. First, they may not wish to remain in the company under a new controller. Secondly, as all shareholders (not just the old controller) should share the premium paid for someone acquiring control, the buyer has to offer all shareholders the highest price he paid for his shares.

Thus investors feared that if they act collectively such that the combined ownership of the parties “acting in concert” exceeds 30% and they seek to change board representation, they would have to make a mandatory bid for the company. It is also understood that the

parties involved would be jointly and severally liable – each could be left with the responsibility to make a full bid.

The Executive of the UK’s Takeover Panel does not believe that the relevant provisions of the Code have either the intention or the effect of acting as a barrier to collective action by asset managers and institutional shareholders. In September 2009, it issued Practice Statement 26 which describes the Executive’s interpretation and how it applies the relevant provisions of the Code in this area. The Statement is at:

<http://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/11/ps26.pdf>

In summary, we understand from the Panel that the risk of collective action by shareholders triggering a mandatory offer requirement under the Takeover Code is negligible in that in general, it could only be triggered if **ALL** of the following are satisfied:

- Shareholders **propose or threaten a “board control-seeking” resolution** to replace directors. In determining whether a proposal is “board-control seeking”, the Panel will have regard to a number of factors, including whether:
 - The **proposed directors have “a significant relationship” with the shareholders such that they are not independent**, e.g. if there has been a previous relationship (employees, directors or officers of the shareholders), there are agreements, arrangements or understandings in place, or the directors are to be remunerated by the shareholders; and
 - The **proposed directors would control the board**, i.e. replacing only the CEO or two or more NEDs would not normally be considered “board control-seeking”.
- Then one or more of the shareholders concerned must acquire interests in shares such that the shares in which they are interested together carry 30% of the voting rights or, if they already hold shares with 30% or more of the voting rights, they acquire any further shares.

Other points:

- Even if a “board control-seeking” resolution is proposed, a mandatory offer would not be required if steps are taken to prevent the acquisition of shares. In the event those steps fail and further shares are acquired, the Panel would be more likely to require the disposal of the relevant shares rather than a mandatory offer to be made.
- Since the relevant provisions were introduced in 2002, no mandatory offers have been required in the context of a “board control-seeking” resolution.

Acquisitions Directive

There are also concerns as to whether collective shareholder action in relation to banks and other financial institutions is covered by the Acquisitions Directive which was implemented in 2009. In summary, the Directive requires regulatory approval before an investor, or such persons acting in concert, acquires a direct or indirect “qualifying holding” in a bank, investment firm or insurance company (broadly speaking a holding of 10% or more of the shares or voting rights).

The Directive does not define when a person is “acting in concert” but the EU Level 3 Committees guidance states: *“persons are ‘acting in concert’ when each of them decides to exercise his rights linked to the shares he acquires in accordance with an explicit or implicit agreement made between them. Notification of the voting rights held collectively by these persons will have to be made to the competent authorities by each of the parties concerned or by one of these parties on behalf of the group of persons acting in concert”.*

This could affect investors’ ability to cooperate, as even an ad hoc agreement or understanding to vote together on an issue could result in the parties being treated as “acting in concert”. There is, therefore, a risk that they would need prior regulatory approval if their holdings together exceed 10%. However, we understand there are concerns that authorities’ procedures (i.e, the FCA) do not tend to envisage such notifications and approvals and the process and time involved could be

an impediment to collective engagement. To address these concerns, it would be necessary to have some clarification of the EU Level 3 guidance that the Directive’s provisions are not triggered by an ad hoc agreement or understanding to vote together on a particular issue.

In this context, as part of the EU Action Plan on European Company Law and Corporate Governance, during 2013, the Commission has undertaken to work closely with the competent national authorities and ESMA with a view to developing guidance to increase legal certainty on the relationship between investor cooperation on corporate governance issues and the rules on acting in concert.

The Action Plan is at:

http://ec.europa.eu/internal_market/company/modern/index_en.htm

Following this, ESMA published in November 2013 a statement which includes a White List of cooperative activities that shareholders can undertake without becoming subject to the concert party rules. The statement also contains guidance on what factors national authorities should consider in order to determine whether investors who work collectively in relation to the appointment of board members are acting in concert.

The ESMA statement is at:

<http://www.esma.europa.eu/content/Information-shareholder-cooperation-and-acting-concert-under-Takeover-Bids-Directive>.

Market abuse

Market abuse is defined in Section 118 of the Financial Services and Markets Act 2000 as inappropriate behaviour relating to qualifying investments on a prescribed market. One category of inappropriate behaviour is where an insider discloses inside information to another person otherwise than in the proper course of the exercise of his employment, profession or duties (improper disclosure). Another is dealing by an insider in qualifying investments, on the basis of inside information possessed by him relating to those investments (insider dealing).

“Inside information” is defined in the Act as information which:

- is of a precise kind;
- is not generally available;
- relates, directly or indirectly, to a company with securities trading on a “prescribed market”; and
- would, if generally available, have a “significant effect” on the price of securities.

Examples of inside information include information that there is about to be a change in the issuer’s credit rating or as to the content of an imminent results announcement or trading update, or information about a potential equity issue or M&A transaction. More subtle examples include the fact that an issuer is contemplating issuing new debt securities or buying back a significant amount of existing securities.

The practice of “pre-sounding” investors is often a necessary precursor to a capital raising or refinancing. “Pre-sounding” is the term given to discussions with investors (prior to announcement of an actual transaction) to gauge their interest in a potential structure or transaction and/or its potential pricing. One attendant risk of such discussions is that non-public, price-sensitive or inside information may be disclosed to the investor.

To facilitate collective engagement any Forum would need to establish an infrastructure to deal with price sensitive information and the secretariat would need to manage the affairs of the Forum so that:

- Participants (whether investors or companies) in the Forum understand and agree that they are not to disseminate confidential or price sensitive information without the consent of other members present in the relevant meeting.
- Engagement Action Group meetings are attended by a member of the secretariat who is a legal or compliance advisor who will be responsible for monitoring the discussion.
- Engagement Action Group meetings at which confidential or price sensitive information may be disclosed must be flagged to Forum participants in advance, who may decide whether or not to take part on the understanding that they may not be permitted to trade in the securities of the relevant company as a result of participating in the meeting.
- Where there has been an inadvertent disclosure of price sensitive information, the secretariat will be responsible for following up with the relevant discloser that an appropriate public disclosure is made promptly.
- Where price sensitive information is either intentionally disclosed to an Engagement Action Group meeting or generated as a result of the discussions, the secretariat will be responsible for reminding the relevant participants of that fact and reiterating its implications.
- In order to limit the period during which a participant in an Engagement Action Group discussion may be in possession of unpublished price sensitive information, especially where it relates to a course of action agreed upon by specific Forum participants in relation to a particular company, action plans will be executed as swiftly as possible. In addition the participants in the discussion may agree that the secretariat makes a public announcement of the relevant information, provided that the release of the information would not in/by itself breach any duty of confidentiality.