

Trustee MasterClass

Corporate governance

This edition of Trustee Masterclass takes a closer look at the concept of corporate governance from a trustee perspective.

What is corporate governance?

Corporate governance can be defined as the system by which companies are directed and controlled. The corporate governance framework specifies the rights and responsibilities of the different participants in the organisation – such as the board, executive management and shareholders.

In the UK, corporate governance is regulated through the Companies Act 2006, the May 2010 UK Corporate Governance Code and associated guidance. This framework provides companies and shareholders with standards of good practice in relation to issues such as board leadership, effectiveness, accountability, remuneration and relations with shareholders.

There is growing consensus that responsible owners of companies have a duty to promote good governance. Furthermore, there is an increasing body of academic research that links well run, i.e. well-governed, companies with better long-term financial performance, which in turn benefits long-term shareholders such as pension funds.

Trustees and corporate governance

It is up to trustees to decide the extent to which active shareholder engagement should play a role in their scheme's investment strategy. However, it is important that their approach to corporate governance is considered explicitly as part of a documented process. Best practice would suggest that trustees:

- ▶ Ensure their investment managers adopt the Stewardship Code, which was published by the Financial Reporting Council in July 2010;
- ▶ Include a statement of the scheme's policy on responsible ownership in the Statement of Investment Principles; and
- ▶ Report periodically to members on the discharge of such responsibilities.

In line with best practice, trustees are also encouraged to consider the potential for engagement to add value when formulating investment strategy and selecting investment managers.

In practice, trustees can either formulate their own governance policy statement or adopt their provider's approach if deemed appropriate. To implement the policy, trustees could pursue an integrated approach, addressing corporate governance through their manager; vote and engage with companies themselves or outsource it to an external governance specialist.

Integrated approach

Practically speaking, most schemes look to their investment manager to implement their corporate governance principles. The integrated model is more straightforward to monitor and ensures consistency between voting and investment decisions. However, trustees need to ensure that corporate governance is not a mechanistic exercise for the manager. Trustees should also be mindful of any potential conflicts of interest. Questions to ask in this context include:

- ▶ Has the manager published a policy on corporate governance engagement and its compliance with the Stewardship Code (required of regulated firms by the Financial Services Authority)?
- ▶ How does the manager monitor the companies in which they invest?
- ▶ Has the manager a clear policy on voting?
- ▶ Does the manager provide regular reports on their stewardship and voting activities?
- ▶ Has the manager clear guidelines on when and how they will escalate their activities to protect and enhance shareholder value?

Insourced approach

Trustees choosing to implement their own policy need to consider the considerable resources required, in particular staff and/or trustee time and a subscription to proxy research. The benefit of insourcing is that the trustees can be certain that the implementation matches the intent of the policy and is in accordance with the principles of the beneficiaries. In addition, there is potentially additional impact from the 'asset owner' undertaking the engagement with companies. Generally, only large funds held in segregated accounts could justify this approach.

Outsourced approach

Using an external governance specialist provides an explicit focus on corporate governance. Trustees can tap into a more specialist skill set and a stronger network. On the other hand, it entails a greater governance burden and also increases the risk of introducing significant inconsistency between the scheme's voting and investment decisions. So, for instance, a scheme could through its governance provider be engaging for governance changes based on policy whereas the investment managers, who tend to be closer to the companies in which they invest, may understand the reason for an unconventional governance approach and accept it by exception. Furthermore, well resourced managers should be able to offer similar levels of expertise and engagement. Ultimately, the choice between the three approaches depends largely on the trustee board's individual circumstances. The key, however, is to ensure that the decision is underpinned by in-depth due diligence and regular monitoring.

An evolving environment

The financial crisis has highlighted the importance of sustainable business practices, one of which being sound corporate governance. The framework that defines good corporate governance in the UK will continue to evolve, influenced by practitioners, UK regulators and policy makers from Europe. New issues, such as board and executive diversity, will come to the fore and the framework will change to accommodate them where they are material to the long-term success of companies. At the same time, public scrutiny of investors and companies seems likely to increase.

Whatever the outcome of these changes, it is clear that corporate governance will remain an important item on the agenda of trustee boards. As well as having a sound understanding of best practice, trustees need to keep abreast of these developments and ensure that, where appropriate, they are reflected in the approach taken by the board or its agents, the investment manager or governance provider. This requires an ongoing educational effort from the trustee board. However, as well as the dedicated section of the trustee toolkit on corporate governance and information provided by organisations such as the National Association of Pension Funds, trustees should also be able to receive some educational support from their investment manager or provider.

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