Good morning, and thank you very much for having me here to talk for the AMNT. The topic I am going to cover today is role that member nominated trustees have to play in corporate governance. A lot of governance is about one very simple issue: who elects the directors of FTSE100 or other large companies? Who gets the votes in our economy? As pension trustees I expect the most important concern you have is how you can best serve the members that have elected you. In turn, corporate governance is important because a large share of your members’ retirement savings will ultimately be invested in company shares. When I first started thinking about this, in my first year teaching law, it happened to be the start of the financial crisis. This was formative in the thinking of many younger academics, including me, and I expect it shaped many of our conceptions of finance and the City. However, the problems of corporate governance are not that new. Back in 1776, Adam Smith wrote in *The Wealth of Nations*, that those in charge of ‘other people’s money’ were prone to ‘negligence and profusion’: they tended to make mistakes and they had a tendency to unjustly enrich themselves at the expense of others. Generally speaking, corporate governance is about how this can be stopped, so that British companies can be made more productive, sustainable and just. What I hope to show you is that, while the problems are not new, your organisation is, and that the AMNT represents one of the most positive developments in UK finance for the last fifty years.

So, I am going to talk about three main things. First, I wanted to give a brief history about where member nominated trustees came from. Second, I will try to summarise how corporate governance works in the UK, and the place of trustees in it. And third, given the rapid economic and financial developments we see, I wanted to point to the role that the AMNT might play in the future.

1. Where did MNTs come from?

So first, where did member nominated trustees come from? MNTs are mostly a 20th century phenomenon, because in the 19th century people were too poor and so occupational pensions were virtually non-existent. When the first state pension system was introduced, only around 5 per cent of the British population had any form of retirement savings. The big change came at the end of the First World War, as part of the government’s plans to create an ‘industrial democracy’. Under the Trade Boards Act 1918, the Ministry of Labour was empowered to require employers and trade unions to form joint committees to manage every aspect of economic life together. One of the areas where employees participated in their workplace was pensions. We have a wonderful example from the Bournville chocolate factory in Birmingham, run by Cadbury, which published a pamphlet on how well it worked. They proudly explained how they had ‘administration of pension funds by trustees representing both sides’. This came from ‘the recognition of the necessity of self-control by the workers of the various clubs and works societies’. Sadly, however, the practice did not become widespread, or last for long because the Ministry of

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1 London School of Economics. Please email me with any correspondence, questions or comments at l.e.mcgughey@lse.ac.uk
3 Bournville Works, *A Works Council in Being* (1922) HD5 118 LSE archives
Labour's functions were cut down in 1922. In any case, throughout the inter-war period, most people still had too little money for occupational pensions. The state pension was by far the most important safety net.

After the Second World War, occupational pensions really took off, and they started to take on great significance for corporate governance. The first reason for the takeoff was that the Trustee Investments Act 1961 changed the law so that any trustee could invest up to half their assets in company shares. Before, shares were seen as too risky to fulfil the ‘prudent person’ requirements. Modern portfolio theory and diversification standards had changed that. The second reason was that trade unions had become much stronger after the War. They had collectively bargained with employers for better occupational pensions. And this is shown in this chart of UK share ownership. The first thing that we can see is that from the 1960s, individual share ownership is on a terminal decline, as institutional investment begins to take over. We can see pensions here, as well as insurance companies, and then a variety of investors that we can collectively call ‘mutual funds’. A lot of this money was also people saving for retirement, just in a slightly different legal form: a life insurance policy, or a managed fund.

The second thing I want to point out quickly is you can see that the relative share of pension money rose to a high point, and then declined relative to other institutional investors after the 1980s. The third thing is this red line: this is globalisation, as the rest of the world began to invest more and more in Britain. We’ll come back to that point in a minute. But we see roughly similar trends across most developed countries.

It was also from this point that the first major discussions began in government about MNTs. In 1973, the Conservative government set up the ‘Occupational Pensions Board’, and soon it recommended that all pensions should have half the trustees elected by employees. In 1976, Labour recommended that legislation be passed. It did not get round to doing this but employers and unions began voluntarily to adopt joint management structures. One survey in 1983 found that almost half of the 120 pension schemes it looked at had some sort of system for members nominating trustees. This was, of course, not an entirely voluntary development because trade unions were still relatively strong. But employers found that the system worked well, and that trustees usually operated in a highly consensual manner. In 1993, the government had asked Roy Goode, Britain’s most important commercial lawyer, to do a report on pensions. The Goode Report recommended that the right of employees and pension beneficiaries to nominate trustees be put in statute. The reason was that ‘members earn their benefits by their work and their contributions. It is their scheme,’ the report went on, ‘in a very real sense and they have a legitimate interest in its management.’ The Pensions Act 1995 did not go all the way: it basically allowed employers to opt out. However, in the Pensions Act 2004, the right for one third of trustees became compulsory in law. And before long, the AMNT was created.

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4 Cave Committee, Report to the Ministry of Labour of the Committee Appointed to Enquire into the Working and Effects of the Trade Board Acts (1922) Cmd 1645. The Ministry had survived outright abolition by the Conservative led coalition with the Liberal party: Geddes Report, Committee on National Expenditure. First interim report of Committee on National Expenditure (1922) Cmd 1581, at 141 ff.
5 T Schuller and J Hyman, ‘Pensions: The Voluntary Growth of Participation’ (1983) 14(1) Industrial Relations Journal 70, 73. At 74-75, of those 57 schemes, there were 3 cases of over 50% codetermination, 16 cases of 50%, 20 cases of 40-49% and 12 of between 33-40% and 6 of under 33%. The employee trustees were nominated 14% by management, 12% by management after an employee election, 16% by trade unions, 28% by all scheme members and 21% by pensions committee or consultative committee.
6 Pension Law Reform (1993) Cm 2342, paras 4.5.15-4.5.18. See also, para 4.5.19, ‘however scrupulous the employer may be, there is no substitute for the discipline of another voice in the decision-making process, who can ensure that the employer-appointed trustees do not allow themselves, consciously or unconsciously, to be unduly influenced by the wishes and concerns of the employer.’
So that is the story of how we got here. This is, however, the history of the private sector. In the public sector, sometimes there are MNTs, sometimes there are not. At the last meeting, we heard how the Local Government Pension Scheme is introducing plans for MNTs, on the back of proposals in the Hutton Report. They are also trying to look at how the pension can be merged, which is important to ensure people’s savings, and taxpayer money, does not get eaten up by administration costs. The other recent development is that the Pensions Act 2008 created a public option fund manager called the National Employment Savings Trust. Everyone will soon be enrolled automatically in a basic defined contribution pension, and by default NEST will manage the investments. The Secretary of State currently holds the power to require that the board of NEST has member nominated trustees. Once the system gets up and smoothly running, and hopefully as soon as possible, I think Steve Webb and everyone here would agree that this would be an excellent idea. The Secretary of State also has the power to require that, not just one third, but a minimum of one half of trustees everywhere be member nominated: all without primary legislation. The point is that the story of pension trustee organisation has just begun.

This is not just a British story. And this is where I come back to that red line which represented globalisation. Around the Commonwealth particularly, there are laws requiring member nominated trustees, from Canada, to India, to Australia and South Africa in both private and public pensions. In fact, Britain has been falling behind, particularly if one looks at Canada or South Africa. The United States has one of the longest traditions of MNTs in what they call ‘Taft-Hartley’ plans in the private sector, and in a majority of state governments in the public sector. A lot of you will have heard of CalPERS, for example: the huge Californian state employee pension plan. This is roughly half run by member nominated trustees. Also, across the European Union, especially in countries like Germany and Sweden, you have codetermination laws that require a third or a half of pension boards, depending on the form of pension, to be member nominated. This is important because we are moving to a system where the majority of investment in UK companies comes from abroad: more than 90 pence in the pound of our foreign investment comes from the EU, the US or the Commonwealth. This means, first of all, that you could form a Global Association of Member Nominated Trustees right now if you wanted. Second, it means that if we want to understand our own corporate governance system, we increasingly need to look abroad to learn how shareholding works there. That said, now I’m just going to focus on how things work here, and what MNTs can do.

2. How UK corporate governance works

The most important thing to realise about corporate governance today is how much it has changed since 50 years ago. During the Great Depression, after the Wall Street Crash, two American academics called Berle and Means wrote that corporations had separated the people who owned companies from the people who controlled them. Berle was one of the most important thinkers on the issue in the 20th century, and also one of the most prominent people involved in the New Deal era. He wrote some of Franklin Delano Roosevelt’s most famous...
speeches.\textsuperscript{10} Unless shareholders had effective rights against corporations, he argued, and just as Adam Smith had said, directors of large companies could unjustly profit from their office at everyone else’s expense. The profit motive and private ownership of property did not work anymore to create an efficient economy when the people who made decisions were not accountable to those affected by them.\textsuperscript{11} They could simply profit from their office, not profit by working hard. This was, however, largely before shareholders became collective institutions: a world that only really took shape as we saw from the 1960s.\textsuperscript{12}

Now we see an even greater separation. Before the shareholder was the person who actually contributed money to a company. If I bought shares, I got a vote. In UK law, we followed Berle’s recommendations to ensure that shareholders can hold directors of companies to account through the vote.\textsuperscript{13} (In most EU countries, employees can as well. The UK has been behind in this respect, even though proposals and legislation have at some point been made by every political party.\textsuperscript{14}) But now, people’s money generally goes through a long investment chain. If you save money in a pension, the employee or beneficiary has pay deducted each month by the employer, and then this money is held on trust. This is where member nominated trustees stand. Some pension funds do the rest: big pension trusts take management and trading in-house. But very often, trustees delegate investment management services to a firm. It could be any of the firms where the AMNT has been having meetings: Henderson, AXA, or another fund manager, like BlackRock, Schroders or State Street. In general it is these fund managers that will become the legal shareholders. These firms are often also insurance companies, and offer mutual fund management products. There is no real separation of function. They cast the votes on all the shares in companies. Together, a small group of fund managers can control virtually every major company in the UK, from the FTSE100 down. The votes they have allow them to hire and fire directors, set directors’ pay, call meetings and make any proposal for the way that the company is run.\textsuperscript{15} In practice, fund managers do not do this vast amount of voting, on the billions and billions of pounds which they control. The person, or people who are in charge of corporate governance will ask what is called a ‘proxy advice company’ to tell them how to vote. Usually, they pay a firm called ‘Institutional Shareholder Services’. ISS has a few hundred staff, who monitor all voting issues. A fund manager essentially tells ISS what its preferred voting policy is and ISS will say how the fund manager would wish to vote. On a few items which come up in the financial news, fund managers will prefer to take an active stance. But most votes are cast electronically, as if by remote control.

The big corporate governance question is whether shareholding institutions are representing the interests of the people whose money is ultimately at stake. Do beneficiaries’ wishes get passed up through the investment chain? Do company directors and fund managers act in ways that reflect the priorities of the people whose money they

\textsuperscript{10} eg FD Roosevelt, \textit{Commonwealth Club Address} (23 September 1932)
\textsuperscript{11} AA Berle and GC Means, \textit{The Modern Corporation and Private Property} (1932)
\textsuperscript{12} Berle saw this as well: AA Berle, ‘Property, Production and Revolution’ (1965) 65 Columbia Law Review 1
\textsuperscript{13} This began with the Companies Act 1947 s 29, and is now in the Companies Act 2006 s 168
\textsuperscript{14} See the South Metropolitan Gas Act 1896, which appears to be the first codetermination law in the world for the gas sector, enacted by the Conservative government; the proposals of the Liberal Party, \textit{The Report of the Industrial Partnership Committee: Partners at Work} (1968) and the report commissioned by the Labour government, but never enacted: \textit{Report of the committee of inquiry on industrial democracy} (1977) Cmnd 6706.
\textsuperscript{15} See the Companies Act 2006 ss 168-169, 303, 292. At the moment, s 439 says that shareholders have a non-binding ‘say on pay’ for company directors. Curiously, in 1862, most companies had binding votes! Nevertheless, a shareholder resolution could easily couple a vote on pay to dismissing the board of directors under the s 168 right, and thus effectively make the vote binding. It is not entirely clear why shareholders have not done this yet.
use? Would pension beneficiaries agree with the stances taken on executive pay? Or reforms to company pension schemes? Or policies generally towards the workforce, the environment, and the community? In fact, UK law gives a clear right for any pension scheme to direct a fund manager how votes should be cast. This comes from an old case in 1929, but the law is completely clear: fund managers must follow instructions they receive. It is just that if no instructions are received, the fund manager can vote the shares so long as, by an especially unhelpful legal standard, it is done in the beneficiaries’ best interests. This leaves pension trustees a choice: they could become active players in corporate governance, or fund managers would continue to determine the priorities for UK companies. In fact, fund managers would seem to be all too glad to get rid of voting responsibility. If you ask a fund manager, chances are they would only be too happy to receive instructions: after all they are in business because they serve their clients. Moreover, you often hear people say things like ‘we are traders, not voters’. Their expertise lies primarily in picking good investments. Corporate governance is secondary. This has been one of the reasons behind the Stewardship Code 2010. It required that shareholding institutions become more active in the use of their votes, and transparent in their voting policies. It wanted shareholder engagement, because it wanted accountable corporate management. The trouble is that fund managers continue to use proxy advice companies like ISS, so they do not really engage. And anyway, they are managing other people’s money: the Stewardship Code does very little about this. One of the most active, engaged investors in the UK happens to the Universities Superannuation Scheme. Why? It has member nominated trustees, it is big, and it takes corporate governance in house. However, it would take some significant work, especially for smaller pension funds to do the same.

3. Options for the future

If member nominated trustees wanted corporate governance to change, there are three basic options. The first is what you could call the ‘nuclear option’ that the Swiss have just taken in a referendum this year. In Switzerland banks play a very similar role in corporate governance to UK fund managers. But in March 2013, the Swiss voted with the second highest percentage ever in a referendum, to ban banks altogether from voting on shares. This means fewer votes get cast in total, but now in Swiss companies it will be the parties who are interested, because they have made a contribution, who get to vote.

The second option is to leave matters to the market. It is easily conceivable that pension trustees could organise, perhaps with the assistance of trade unions, to develop a system for deciding how they would like to vote on various issues, in the same way that ISS does now. Pension trustees, even in the smaller plans, could then enter voting instructions electronically at low cost. This is easily conceivable and do-able, but it would require significant effort, and it would not touch the money that is wrapped into life insurance policies, or mutual funds more generally.

A third option was proposed some years ago in Germany, for their banks. It suggested that in each financial

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16 Kirby v Wilkins [1929] 2 Ch 444, Romer J holding a bare trustee has a duty to follow instructions from an absolutely entitled beneficiary, or vote in their best interests. Also, in Butt v Kelton [1952] Ch 197, Romer LJ held that beneficiaries can compel one to vote, and the court could exercise a power if beneficiaries were among themselves in disagreement.
institution, the corporate governance department could be elected by the people who had provided the money. The first and third options would require legislation, legislation to which the AMNT would undoubtedly have a valuable contribution to make. In essence this would separate the voting function from the City, and at the same time undo the separation of ownership and control in corporate governance: a more democratic financial services sector, more democratic companies, and a more democratic economy.

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It was said at the height the financial crisis that the only innovation in the City or Wall Street in the last thirty years had been the ATM. But now, I think that is no longer true: your organisation, the AMNT, pension trustees self-organising, is the most important development in finance in the last fifty years. And I expect that for the role of MNTs in corporate governance, the most interesting time has only just begun.

\[\text{nb Kraft's (ie Cadbury's) top 10 shareholders in 2013} \]
%  
State Street Corporation 5.02  
Vanguard Group, Inc. (The) 4.72  
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= 28.25 %