Association of Member Nominated Trustees

Bringing shareholder voting into the 21st Century

An examination of the barriers to effective stewardship and how to overcome them

Forewords

GUY OPPERMAN MP, MINISTER FOR PENSIONS AND FINANCIAL INCLUSION

I want to bring real change on the issue of voting.

In 2019, I made changes to the law to clarify trustees' fiduciary duties in relation to environmental, social and governance issues and to improve their stewardship and voting practices. It was my intention to remove some of the – real and perceived – barriers to trustees taking action in these areas. I also legislated to require trustees to report on how they are implementing their policies. I did not want another 'tick box' exercise in which trustees or, perhaps more likely, their advisers, go through the motions of compliance. I wanted trustees to truly engage with their duties as fiduciaries and with their rights as shareholders.

It is therefore a disappointment to me that trustees still face challenges when seeking to exercise their rights to vote in line with their voting policies. In particular, where trustees are using pooled fund arrangements that otherwise represent cost-effective options for investing members' money.

In my view, this is not simply a frustration for trustees who face obstacles in complying with the spirit of the law. It is also a frustration for those of us who care about the role institutional investors play in society, investing ordinary people's hard-earned savings in the real economy around us. There is such power in greater engagement by pension schemes with the companies and assets in which they invest. However, as noted in this timely report, there is sometimes a gap between what pension trustees wish to do and their ability to make it happen.

As a policymaker, I can reflect on whether we have asked too much of pension trustees. But I do not believe this to be the case. We have held trustees to a standard commensurate with their role in the financial system, and in society more widely. However, they are not the only actors in the investment chain – fund managers also need to step up and to play their role, for their clients. This report identifies where the real barriers lie and possible solutions. I therefore welcome its contribution to this important discussion – and I look forward to working with the Association of Member Nominated Trustees. I agree on the recommendation for a working group to develop solutions that will unlock further progress on stewardship and engagement.

I am determined we are going to bring about real change on this issue.

amnt Association of Member Nominated Trustees

JANICE TURNER
CO-CHAIR, AMNT

When I first began to create the AMNT's Red Lines voting policy back in 2012, it was done with advice from fund managers along with players right across the financial services industry and the voting chain, in addition to advice on climate change voting policy from the Carbon Disclosure Project.

It came as a great surprise in 2016 therefore, after the Red Lines had been launched, when reports came in from trustees that their fund managers were refusing to accept their voting policy, even on a comply or explain basis. AMNT's asset owner initiative aims to empower trustees who invest in pooled funds to send a strong signal to investee companies on ESG issues, with their financial intermediaries supporting them in this - a surprisingly controversial idea it seemed.

Since then, AMNT has encountered barriers at every turn within the stewardship chain in our efforts to secure asset owners' rights, not only with regard to voting policy implementation but also on transparency and quality of fund managers' own voting policies and scheme specific ESG and stewardship reporting. Fund managers whose policy falls far short of what is needed have refused to accept their clients' policies, and also refused to align their own to that of their clients. There is now a clash between the asset owners and the fund managers over who should direct the voting policy of the investments. This is an untenable situation that requires immediate attention especially given the new, greater regulatory obligations placed upon trustees.

This report echoes the challenges we have encountered in our campaign but it also provides practical steps on how to move forward to address the problem. We are delighted that the Minister has endorsed our recommendation to establish a Government-led industry group to develop solutions and we look forward to participating in this.

One of the interviewees from our study stated that if we were to engineer the voting infrastructure from scratch it would not be created as it is currently configured: it is a broken system. The same holds true for the financial services industry regarding ESG and stewardship. The power needs to shift from fund managers to pension funds - the providers of capital - so that their stewardship objectives and priorities can be implemented. Business models of financial intermediaries need to shift to reflect this new reality, and for them to see the competitive advantages of doing so. I am confident that this working group can help to make this a reality.

UKSIF
UK Sustainable Investment and Finance Association

SIMON HOWARD*
CHIEF EXECUTIVE OFFICER, UKSIF

UKSIF welcomes this timely contribution to the evolving debate on stewardship in the UK. The stewardship expectations placed on trustees – and by extension other fiduciaries – are rising sharply and everyone in financial services should recognise that existing methods may simply not match the new requirements. Whilst the AMNT report looks at stewardship and voting in pension funds, other stakeholders are considering the issue for other types of asset owner. This subject is likely to receive more attention not less as time passes. We would hope that the industry would capitalise on the opportunities for growth and development in pensions that lie behind many of the answers interviewees gave in this research, and we would expect them to look to take them into other areas as well.

In particular we welcome the support of the Minister for Pensions for a Government-led working-group. It is by combining the insight of experts from the likes of UKSIF, AMNT, regulators and Whitehall that we can make substantial progress and maintain the UK's lead in stewardship. We hope the working group will be broad-based and reflect expert opinion from sector specialists, and we would expect UKSIF members to engage enthusiastically. At the same time we look forward to this initiative helping financial services firms of all kinds grow by meeting the expanding needs of asset owners.

** Simon retired from UKSIF in October 2020.*

PRI Principles for Responsible Investment

FIONA REYNOLDS
CEO, PRINCIPLES FOR RESPONSIBLE INVESTMENT

Investors have a number of key levers which give them both the power and potential to influence real-world outcomes, at scale. Stewardship is one of the most significant of these levers, providing the means by which investors most directly influence companies, markets and economies, and in turn, society and the environment at large.

Over the years we've seen industry capabilities develop to meet active ownership needs and affirmation from regulators in the form of stewardship codes in many countries, including here in the UK. However, it's clear that in spite of this progress, the aggregate impact of current stewardship practices is falling short and failing to meaningfully reduce systemic risks or address the Sustainable Development Goals.

To realise the full potential of stewardship, it's time to increase our ambitions. So, last year at the PRI we launched our Active Ownership 2.0 programme focusing on how we believe stewardship needs to evolve. It's an aspirational standard for improved stewardship which builds on existing practice and expertise, but explicitly prioritises the seeking of outcomes over process and activity, and common goals over narrow interests. We'll be producing guidance on practical implementation and we will also be working to align PRI's Reporting and Assessment framework in order to encourage and reward the leadership that is already starting to emerge in this area.

However, in order to raise the bar on stewardship, addressing roadblocks which are holding investors back will be critical. The issue of split voting and allowing asset owners the right to have their voting policies implemented by their fund managers presents a serious obstacle that needs to be addressed. I therefore welcome this important report and its recommendations to help overcome barriers to executing segregated voting in pooled funds.

It's fantastic to have the support of the Minister for Pensions and Financial Inclusion in this vital conversation and in the development of a solution-oriented working group to take this work forward.

About the author

PROFESSOR IAIN CLACHER

Professor Iain Clacher is an expert on pensions and retirement savings, most notably on retirement decision-making, pension fund investment and governance, and fund management costs and fees. A central feature of Iain's academic research is its translation to practice, and it has been used to advise a range of businesses, regulators, and policy makers both in the UK and internationally. He has advised organisations including, The CERN Pension Fund, The City of London Corporation, The Work Foundation, The Pensions and Lifetime Savings Association, Aon, The Office for National Statistics, and the Financial Conduct Authority. Most recently he was the expert advisor to the European Economic and Social Committee on Pan European Pension Products and was a board member of the Institutional Disclosure Working Group of the Financial Conduct Authority, which established a cost and fee disclosure template for asset management, which in now the industry standard.

Acknowledgements

LEANNE CLEMENTS, PROJECT LEAD, AMNT

Leanne Clements joined the AMNT as Campaign Manager for Red Line Voting in March 2017. Leanne is responsible for supporting the adoption and implementation of Red Line Voting policies, by working with AMNT and its members, fund managers, policy makers as well as other important actors in the investment chain. Prior to this role, Leanne led the responsible investment strategies at three different UK pension schemes. Prior to that, she worked at a corporate governance and shareholder advisory consultancy, most notably conducting voting policy generation and executing voting instructions for UK pension schemes. Prior to her career in the UK, she worked in her native Canada as an environmental consultant for an engineering firm conducting contaminated site investigations for financial clients.

AMNT would like to thank Guy Opperman MP, Minister for Pensions and Financial Inclusion and Mr. David Farrar, Senior Policy Manager at the Department for Work and Pensions for their continued support not only for this report but for AMNT's campaign activities on client directed voting.

Professor Iain Clacher would like to thank all the interviewees who so generously gave up their time to speak to him about the voting chain in general, their part in it, and also the challenges historical and current. He would also like to give a special note of thank to Leanne Clements who was AMNT's project lead. Without Leanne's boundless energy and persistence this project would not have been possible, nor would it have had such significant reach and scope.

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Executive Summary

> **If the UK regulatory environment expects trustees to develop voting policies and have them implemented, trustees need the support of the fund management industry to do so. The current system may no longer be fit for purpose and there is now arguably an emerging governance gap.**

Recent UK regulatory developments from the Department for Work and Pensions, and most notably, the 2020 Stewardship Code, have placed a greater emphasis on trustees to develop their own approach to stewardship, and not to delegate that responsibility to their fund managers without adequate oversight. More specifically, trustees must integrate environmental, social, and governance (ESG) issues into their investment strategy should they consider them to be financially material, as well as holding their fund managers to account for their stewardship, including voting.

Given the above regulatory requirements, it stands to reason that pension fund trustees need to develop voting policies on ESG issues of concern to the scheme and its long-term goals. However, there are different options trustees may consider regarding how these policies are created, with three key examples provided below:

- For larger schemes with internally managed funds: trustees could exercise their voting rights in-house, with the support of a stewardship team and an external proxy voting advisor (in the same way as many fund managers do).
- For those schemes with externally managed funds: fund managers could report against their clients' voting policies, so that trustees could understand where their fund manager's policy deviates from that of the trustees. Under this approach there could also be a scenario where a fund manager follows its own policy, but as part of the mandate negotiations with the asset owner, allows some limited deviations from it. The fund manager, in specific cases, would therefore vote based on asset owner wishes rather than manager policy.
- The third approach is for trustees to have their fund manager directly implement their scheme-specific policy, on a comply or explain basis, and provide appropriate reporting.

All these approaches are acceptable under the new regulatory developments in the sector. However, the latter two, which involve external fund managers, have faced difficulties in implementation. The subject of this report concerns the third approach (highlighted in bold) of having clients' voting policies implemented by fund managers, particularly in pooled funds.

If the UK regulatory environment expects trustees to develop voting policies and have them implemented, trustees need the support of the fund management industry to do so. At a minimum, trustees need fund managers to report and explain when and why they have deviated from client voting policies i.e. where client policies set a benchmark for voting. However, the fund management industry has, in most cases, refused to do so in pooled fund arrangements. Over the years, many barriers have been presented as to why this is not possible. However, there has been a paradigm shift in regulation. This is an

acknowledgement of the fundamental role pension funds have, as providers of long-term patient capital, in addressing global challenges such as climate change. Consequently, the current system may no longer be fit for purpose and there is now an emerging governance gap, which is not good for stewardship or long-term investment in the real economy. This paper examines this governance gap, and explores the barriers to split voting in pooled fund arrangements in the UK market, so that practical solutions can be developed in order to allow asset owners (pension funds) to meet their regulatory obligations.

REPORTED BARRIERS TO SPLIT VOTING

TECHNICAL BARRIERS

A majority of pooled funds are held in omnibus accounts with a custodian. This means that custodians register the shares in the name of a nominee company with an omnibus account, where the shares of multiple clients (e.g. fund managers) are registered under one name, for example, XYZ Nominees Limited. There may be many fund managers – each with multiple pension fund clients - operating different pooled funds that the custodian has put in the same omnibus account. The issuer/investee company will see on its share register that "XYZ Nominees Limited" owns X number of shares. This system creates opacity around who is the beneficial owner (e.g. individual pension funds) and therefore how many votes are correctly attributable to that owner.

The fact that they are **pooled funds** being held in an omnibus account compounds the issue further. For many fund managers it seems, the splitting of the vote, if it were to be done, would be a manual process in a pooled fund. This was deemed as a barrier to split voting, especially if a large number of clients required it. This issue has arisen because of the ad hoc evolution of the underlying technical infrastructure and systems that exist in the intermediated model of fund management. A view, raised time and again across interviews by those involved in the voting chain, was that if the voting system were to be built today, nobody would build it as currently configured.

Sophisticated electronic systems exist globally for trading and many other complex activities both within and outside of fund management, to still be reliant on manual input is a concern and reflects the lack of investment in the voting infrastructure. This view was also widely supported across the interviews undertaken for this study.

Investment in the proxy voting system has not, either historically or currently, been a priority for much of the fund management industry, and consequently, for the custodian industry either. It has been 14 years since the Myners Report[2] brought to light many issues about the voting chain, and these issues are as relevant today as they were then. The reality today is that voting processes built on legacy systems are not fit for purpose given UK regulatory requirements. In order to allow for effective stewardship, there needs to be significant investment or disruption to the current system to engender real change.

> **"If the voting system were to be built today, nobody would build it as currently configured."**

THE COSTS OF SPLITTING THE VOTE

Cost was cited as a barrier to split voting, especially as it relates to its manual processes. This purportedly requires extra resource/investment to deal with different client voting policies. An attempt was made to determine how much extra it would cost to implement a custom voting policy in a pooled fund. While no reliable figure was identified, the exercise has raised the following important questions for the industry to consider:

[1] Please refer to http://www.shareholdercoalition.com/sites/default/files/Myners%20Report%201-04_0.pdf, http://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/489357/b is-16-20-intermediated-shareholding-model.pdf
[2] http://www.shareholdercoalition.com/sites/default/files/Myners%20Report%201-04_0.pdf

> Wouldn't this "prohibitive cost", if it did exist, be a function of current, ageing technology, which most interviewees agreed is in need of investment? In which case if this issue was resolved, would this not serve to at least partially if not wholly address the issue?

> Is the cost burden based on the assumption that each client policy would be implemented separately? If so, it would not appear to be a realistic assumption and overestimates the time (and cost) required. There are a lot of routine items in which all clients would either not have a policy or have the same one as the fund manager. In these cases, there are no manual overrides (and no additional costs). Thus, overrides would only be expected to occur in select circumstances.

> To what degree is the cost genuinely prohibitive (how much are we really talking about?) or is it inertia? Is cost merely an excuse for inaction[3]?

Custody arrangements that have developed over decades are also cited as a problem. Much of the structure that we see today, and the use of omnibus accounts, stems from allowing custodians to minimise costs. There was no evidence presented throughout this study to suggest that split voting cannot be done in an omnibus account, thus added costs do not necessarily need to be incurred. Interestingly and in addition, there was no answer provided as to what the order of magnitude in cost difference is between a designated and omnibus account. This may be a function of being 'put on the spot' in an interview situation but does at the same time raise questions of cost transparency. If there is a significant cost difference that is a barrier, then this is fundamental to being able to understand the real cost of stewardship.

One interviewee stated that a pension fund they worked with was quoted the same cost by the custodian to operate a designated account as an omnibus account in an RfP. Custodians are therefore prepared to absorb any "costs"associated with operating a designated account in some circumstances. Asset manager clients, and by extension their asset owner clients, may not therefore have to pay extra for a designated account should they wish to switch.

Overall, the issue of underinvestment in the stewardship function raises one of the major open questions and challenges for the pensions and financial services industry: who pays for the investment needed?

LEGAL ISSUES AND AUDIT RISK

For most investors in UK shares, the legal owner is a broker or custodian bank which keeps the shares in trust using a nominee name (in an omnibus account). If the asset owner had a segregated mandate in an omnibus account, then the asset owner would be classified as the "beneficial owner". However, within a pooled fund in an omnibus account, ownership becomes opaque.

One argument that has been used historically for voting residing with fund managers is that in a pooled fund, the pension fund buys units and the fund manager owns the underlying shares. There are a range of perspectives across the interviews on what this structure implies for voting, and there was no consensus as to what the actual legal position is, or the extent to which this is an issue. A forensic analysis of the legal barriers to share ownership are not for this report. Nevertheless, it is important to note two points: first, that regardless of legal ownership this does not prevent fund managers from choosing to respect their clients' voting policy, and second, there is evidence of some fund managers splitting the vote for select clients. The question is therefore not one of legal barriers as this is already happening in practice. It is imperative that clarity is given on this issue. This ambiguity may be what is hampering some fund managers being pro-active in this space, and for others it may be a reason for not doing anything.

Another argument used for not splitting the vote is that there is too much risk inherent in the process of splitting the vote. However, the fragmented systems and lack of investment in the infrastructure that underpin the voting chain, means that there is an excessive amount of human input into what should be an automated process given modern technology and systems. The position that there is an inherent risk of a manual process introducing error cannot be disputed. From an operational perspective, to be cautious where liability may be incurred is prudent. However, this risk is due to underinvestment and the complex and disjointed structure of the current voting chain.

[3] FCA Asset Management Market Study: Final Report (MS 15/2.3) - https://www.fca.org.uk/publication/marketstudies/ms15-2-3.pdf. Profit margin of 36% is not just pooled funds. More details on profit calculation can be found here: https://www.fca.org.uk/publication/market-studies/ms15- 2-3-annex-1.pdf

CULTURAL BARRIERS

Trustees and investment consultants

In discussions about the lack of involvement by pension scheme trustees in the development of ESG policies, an oft-repeated stance has been to blame the trustees for lack of interest. This is a rather simplistic view of trustees and is potentially damaging to progress, as it represents a failure to understand the environment in which trustees operate.

Trustees for whom stewardship was a priority over the past decade and more, in the face of no support from the Pensions Regulator (prior to the more recent regulatory changes), fund managers and the investment consultants, found themselves having to a) persuade their own fellow trustee board members; b) raise it at board level with their consultants and in some cases in opposition to the consultant; and
c) challenge their fund managers.

This reality was and may well remain a major contributing factor to the lack of engagement of trustees on ESG and stewardship. For those trustees that are cynical about stewardship and its value or are unaware of its importance, there is little to no chance that this view can be altered, particularly if there is no investment consultant and fund manager support that makes a positive and compelling case for the importance of these issues.

Fund managers

Two major issues or points of debate that have been identified through the interview process are **stewardship as a source of competitive advantage, and underinvestment in the stewardship function.**

One basic market solution suggested was that if trustees are not happy with their fund manager's voting policy, they should take their business elsewhere. This ignores the fact that investment consultants' role includes professional assistance of trustees in this area. A common view from the fund management community was also that they have the expertise to deal with ESG matters that the asset owners do not have. However, the AMNT's study of the publicly available voting policies and practices of 42 fund managers indicated that few fund managers had what AMNT considers best practice voting policies and guidelines on climate change and gender and ethnic diversity. For example, 20 major fund managers failed to even mention climate change in their voting policies. Similarly, ShareAction's recent report on asset manager responses to climate change shareholder resolutions showed very different levels of support for proposed climate resolutions across fund managers.

The first major issue raised by some interviewees from the fund management industry was that they would like to see a "market in stewardship", and for it to become a source of competitive advantage. There is an open question as to whether stewardship should be a product to sell, as opposed to a set of standards which all fund managers should follow to ensure alignment with their clients' long-term interests.

Intentionally or not, such a statement could be seen as placing the emphasis on the fund managers' relative expertise in this area versus fund managers and asset owners working together to achieve the latter's specific stewardship objectives. It also may distract from the key systemic issues that need to be resolved, such as updating structural requirements for effective stewardship e.g. voting. Given the complexities involved, further industry discussion is warranted on the issue of achieving a "market in stewardship" and what this would mean in practice to ensure:

> Any market solution places asset owners at the heart of the stewardship agenda allowing them to fulfil their fiduciary duty rather than being sold a stewardship product i.e. a 'one-size-fits-all' approach.

> Addresses the systemic issues that are barriers to effective stewardship (e.g., voting infrastructure issues, accepting client policies etc).

The second major issue identified during interviews was underinvestment in the stewardship function. This view is set out in stark relief in a recent report with regards to stewardship teams in passive management, and the enormous task that engaging with 10,000 companies entails, "the practical task list alone necessitates for bigger teams and the value proposition further justifies increased resourcing".[4] Outside of the UK, this issue has also been recognised as a major barrier to effective stewardship and governance.[5]

[4] https://www.willistowerswatson.com/en-GB/Insights/2019/04/investor-stewardship-one-hand-on-the-wheel
[5] See, Bebchuk, L. and Hirst, S. (2019). Index Funds and the Future of Corporate Governance: Theory, Evidence and Policy, Columbia Law Review, Vol. 119 No. 8 pp 2029-2145.

The importance of this issue should not be underestimated, as it represents a key barrier to not only splitting the vote, but also the industry being able to maximize the financial value that stewardship brings[6].

CONCLUSIONS AND RECOMMENDATIONS

The findings of the report, as set out here and at the end of the report, result in three overarching conclusions:

- The barriers presented to split voting in pooled funds are not insurmountable, especially as some fund managers have already been doing this for some clients. Put simply, asset owners' policies could be implemented by fund managers if there was the will to do so.
- Whilst a lack of will represents a key driver for inertia in addressing the issue, long-term underinvestment in the voting system means that it is no longer fit for purpose. The voting system needs urgent reform. There needs to be a simplification of the voting chain and investment in technology to enable the effective stewardship of pension fund investments for the long run.
- While asset owners need to be more proactive in their stewardship approach, they cannot do so without the support of their fund managers and investment consultants.

Recommendations for future action are discussed below and divided into short and long-term objectives. Given the complexity of the issue, a range of solutions are required to affect real change in this area.

SHORT TERM

FUND MANAGERS

There are specific areas within the new Stewardship Code which, if implemented by fund managers in the spirit as well as the letter, would go far to resolve this issue.

Under the new Code, fund managers should:

- **Explain how assets have been managed in alignment with clients' investment and stewardship policies (Principle 6, activity).**
- **Explain where they have not managed assets in alignment with clients' investment and stewardship policies, and the reason for this (Principle 6, outcomes).**
- **For listed equity assets, disclose their policy on allowing clients to direct voting in pooled accounts (Principle 12, context).**
- **Demonstrate that their governance, resources, and incentives support stewardship (Principle 2).**

The requirement to explain how assets have been managed in alignment with clients' policies, as highlighted in bold above, is key. However, the power of this reporting requirement is only as great as the willingness of the fund management industry to cooperate on this issue.

Fund managers should also report how aligned their own "house" voting policies (and voting outcomes) are with their clients' policies.

[6] Initial findings from academic research led by Professor Elroy Dimson show the financial impact of successful engagement. See Elroy Dimson, " How institutional investors' collective engagement on ESG issues create value for investors and corporations: A configurational analysis,", Judge Business School, Cambridge University, London Business School; Chair of Strategy Council, Norwegian GPFG; Director of FTSE International, 2017.

The advantage of this would be that reporting would be on the asset owners' policy rather than that of the fund managers. Currently, if a fund manager chooses not to have a policy on an ESG issue, or not to engage or vote on it, they may omit any mention of it in their current reports. By reporting against trustee policies, it would become much easier for trustees to understand how fund managers are fulfilling the policies that the trustees consider important. This approach would also make it easier for fund managers to see where their policies differ from those of their clients. For example, if an asset owner has adopted the AMNT's Red Line Voting policies, they would have a clear policy on climate change and the necessity to work to limit global warming to below 2 degrees. Any fund manager whose voting policies did not mention climate change would therefore have to justify that.

This type of reporting would bring greater accountability and should provoke far more effective and efficient discussion on stewardship between fund managers and their clients. Since fund managers would have to report against the client's policy, and many pension schemes have several fund managers, this approach would enable the client to compare fund managers with each other on a like-for-like basis. Such a change would represent a significant shift in accountability and transparency on this key issue. As such, it might begin to create competition between fund managers on issues of stewardship and their ability to deliver this, as trustees would be able to make comparisons across funds. Whilst this does not address the focus of this report on split-voting in pooled funds, this does at least advance the issue of potential misalignment between asset owners and fund managers.

ASSET OWNERS

The UK regulatory signalling is clear for trustees on the matter of stewardship – asset owners must develop policies on ESG issues that they consider to be financially material in their investments. Whilst there may be flexibility as to the content of that policy i.e. whether the policy is to be directly implemented by fund managers or used as a benchmarking tool to evaluate/compare fund managers, trustees must have a policy on any ESG issues they consider financially material. Asset owners can no longer outsource their stewardship responsibilities to fund managers with no oversight.

For those trustees that wish to have their voting policies directly implemented by their fund managers, they should write to their potential and existing fund managers asking how they plan to adhere to the new Stewardship Code requirements described above (most notably those in bold). In addition, trustees should also conduct a benchmarking analysis of their voting policies against that of their fund managers. The formal feedback received from the fund managers on these issues should inform the trustees' fund manager selection, appointment, and ongoing monitoring processes with investment consultants supporting trustees in this endeavour.

Trustees should also write to their investment consultants asking how they plan to support them in their efforts to have their voting policies implemented, citing the new Stewardship Code reporting requirements.

Trustees can also use resources such as the AMNT's trustee guide to help in holding their investment consultants to account for the quality of their ESG advice[7]. If the quality of the advice is not meeting trustee expectations and they are not getting the support they need in this regulatory environment, consideration should be given to changing their advisor to one that can better support them in meeting their regulatory obligations.

[7] https://amnt.org/holding-investment-consultants-to-account-a-guide-for-trustees/

INVESTMENT CONSULTANTS

Investment consultants have a crucial role as gatekeepers between asset owners and the fund management industry. Therefore, they have an important responsibility to not only serve their asset owner clients' individual best interests as highlighted in the previous section, but to also address barriers that impede asset owners' ability to exercise their stewardship responsibilities. As such, this would include supporting trustees in the following ways:

- **Development of their stewardship and ESG policies as per regulatory requirements. The emphasis should be on the provision of tailored advice to trustees on policy development, versus a consultants' standard policy. This avoids asset owners outsourcing and delegating their stewardship responsibilities to investment consultants.**
- **To have their voting policies implemented by their fund managers, if that is the way in which a trustee board wants to meet their stewardship obligations. Put simply, investment consultants should hold any fund manager to account for their unwillingness to accept client voting policies. In practical terms, this means the unwillingness of any fund manager to accept client voting policies should be reflected in the investment consultant's fund manager rating system. This could include the downgrading of a fund manager depending on the internal process for fund manager evaluation on stewardship/ESG considerations.**

More broadly, investment consultants should sign up to the Stewardship Code[8] for service providers. They should be held to account by their asset owner clients in the first instance if they do not sign up to the Code and secondly if they do not adhere to it. In the context of this study, the following elements of the Stewardship Code are of relevance for investment consultants, if signatories they should:

- **Disclose an assessment of how effective they have been in serving the best interests of clients (Principle 1 Outcome)**
- **Identify and manage conflicts of interest and put the best interests of clients first (Principle 3 – All)**
- **Explain how their services best support clients' stewardship (Principle 5, Activity)**
- **Explain how they have taken account of clients' views and feedback in the provision of their services (Principle 5, Outcome)**
- **Identify and respond to market-wide and systemic risks to promote a well- functioning financial system (Principle 4 – All)**

CUSTODIAL ARRANGEMENTS – DESIGNATED VERSUS OMNIBUS ACCOUNTS

This report also identified concerns regarding whether there are actual cost differences between operating a designated versus an omnibus account.

Although it wouldn't entirely solve the problem, if asset owners were able to switch to designated accounts within a pooled fund mandate it would help to better identify individual clients within the pooled funds, and thus obtain more accurate vote splitting. It would also help to achieve greater end-to-end vote transparency and thus help to provide confirmation that the votes had been properly cast.

The FCA recently identified omnibus accounts as being a barrier to effective stewardship in its October 2019 feedback on building a regulatory framework for effective stewardship[9]. The Law Commission is investigating the legal position around some of these issues. Given this, the suggestion that designated accounts should be used to improve transparency in ownership is not out of line with ongoing policy debates.

[8] https://www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship-Code_Dec-19-Final-Corrected.pdf
[9] https://www.fca.org.uk/publication/feedback/fs19-7.pdf

MEDIUM TO LONG TERM: THE NEED FOR AN INDUSTRY WORKING GROUP WITH SUPPORT FROM REGULATORY BODIES

There are many challenges highlighted by this report that cannot simply be resolved through contractual arrangements between the asset owner and the fund manager. The industry (notably asset owners, fund managers, and investment consultants) must come together to develop solutions.

Given that these challenges can be viewed as a form of market failure, the most effective and practical way forward is the creation of a government-led working group to address:

The overly complex and archaic voting infrastructure. Addressing this issue will go a long way to tackling the technological barriers highlighted by the industry to splitting the vote and will also have additional benefits e.g. vote confirmation.

Underinvestment in the stewardship function in fund management. Fund managers need to adjust their business models to reflect the new regulatory requirements of their asset owner clients. It can no longer be a legitimate position for a fund manager to simply cite lack of investment, in whatever form that might be e.g., dedicated RI staff, training for portfolio managers on ESG issues etc. as a reason for maintaining the status quo of not implementing client policies.

Transparency of voting policies and outcomes. Fund managers do not, on balance, provide enough information in their public voting policies so that asset owners can effectively benchmark the fund manager's policies against their own, and if needed, challenge the fund manager. The FCA's commitment to evaluating the voting policies of fund managers, as outlined in their discussion document on the effectiveness of stewardship, suggests that how things stand is no longer acceptable.[10]

Scheme-specific reporting requirements. It is important that trustees drive the reporting content that they need to be effective fiduciaries. With tailored and specific information, trustees can demonstrate how they are meeting their obligations and can hold their fund managers and through them investee companies to account in instances where there is significant disagreement on an issue. Such information will also allow trustees to benchmark asset managers and therefore allow asset managers to demonstrate their expertise and leadership on ESG issues.

The working group should be led by the DWP. It should be balanced so that asset owners from a range of small, medium, and large schemes are included. The rest of the working group would be comprised of all parts of the voting chain, including issuers as well as regulatory representatives. Crucially, the composition of the panel should ensure a majority voice is given to asset owners. Given the array of fund managers and intermediaries involved, it would be easy for representation to skew to over-representation of asset managers and intermediaries. However, what is crucial in all of this, is that any working group convened would be able to develop a market-based consensus driven solution, with regulation being considered only as a last resort.

In conclusion, given that the barriers identified in this report are not insurmountable, action needs to be taken now to address the impasse that exists between the fund management industry and its asset owner clients. Issues such as the climate emergency put even more pressure on the stewardship chain to ensure that beneficiaries long-term interests are protected. With the support of policy makers, it is hoped that this report forms the basis for a constructive dialogue between fund managers, investment consultants, and their asset owner clients, as well as the rest of the voting chain, to develop practical and actionable solutions to this fundamental issue.

[10] The recent FCA workshop in February 2020, Aligning Stewardship Objectives Across the Institutional Investment Community, is indicative of the shifts and change in direction in this area.

1.0 Introduction

Recent UK regulatory developments, most notably from the Department for Work and Pensions and the newly released 2020 Stewardship Code, have placed a greater emphasis on trustees to develop their own approach to stewardship, and to not simply delegate that responsibility to their fund managers without adequate oversight. More specifically, trustees must integrate environmental, social, and governance (ESG) issues into their investment strategy, should they consider them to be financially material, as well as hold their fund managers to account for their stewardship approach, including voting.

Given these regulatory requirements, it stands to reason that trustees need to develop voting policies on ESG issues that are appropriate to the specific pension scheme of which they are a trustee. However, there are different options trustees may consider regarding how these policies are utilised, with three key examples provided below.

- For larger schemes with internally managed funds, trustees could exercise their voting rights in-house, with the support of a stewardship team and an external proxy voting advisor (in the same way as many fund managers do).
- For those schemes with externally managed funds, fund managers could report against their clients' voting policies, so that trustees could understand where their fund manager's policy deviates from that of the trustees. Under this approach there could also be a scenario where a fund manager follows its own policy, but as part of mandate negotiations with the asset owner, allows some limited deviations from it. The fund manager, in specific cases, would therefore vote based on asset owner wishes rather than manager policy.
- The third approach is for trustees to have their fund manager directly implement their scheme-specific policy, on a comply or explain basis, and provide appropriate reporting.

It is important to emphasise the importance of the "explain" mechanism in this third approach. In line with UK governance practice since the 1992 Cadbury Report[12], a principles-based approach to corporate governance and stewardship is essential, as it recognises that there is no 'one-size-fits-all' solution. A fund manager should not therefore simply press a button and vote in alignment with the client's policy, without care to legitimate circumstances which may compel the manager to deviate from that policy e.g., engagement. However, any deviations should be fully explained and reported to the client on a regular basis.

All the above approaches are compliant with new regulatory developments. However, the latter two, which involve broader engagement with the fund management industry, have faced difficulties in implementation. As noted in the executive summary, the subject of this report concerns the third approach – having clients' voting policies implemented by fund managers, particularly in pooled funds.

Those trustees, who wish to implement their own policies in pooled fund arrangements, need to be able to control their voting rights. At a practical level, this means that the trustee should be able to expect the following:

- Their voting policy to be implemented by an external fund manager whether pension fund assets are held in segregated or pooled mandates[11]. In the case of pooled mandates, this means that fund managers would need to split the vote to accommodate the different voting policies of different asset owners[13].
- As mentioned above, instances in which the fund manager deviates from the trustees' voting policy should be formally explained through appropriate reporting i.e. "comply or explain".
- Full voting transparency such that their vote is easy to identify i.e. the issuer/investee company can identify who owns which shares.

[11] https://ecgi.global/sites/default/files//codes/documents/cadbury.pdf
[12] For the difference between segregated and pooled mandates, please refer to the Glossary at the end of this report.
[13] Further details regarding the technicalities of splitting the vote in a pooled fund arrangement can be found in subsequent sections of this report.

The rationale for investment in pooled funds is that this structure allows a broader range of investors, including pension funds, to be in the same fund, thereby achieving scale and lowering the costs of investment compared to a segregated mandate. There are also other non-cost related reasons why trustees are directed towards pooled funds e.g. price transparency of a single fund or ease of hosting on investment platforms. However, this reduction in costs has come at a price, which is the loss of the ability to vote. For a variety of reasons, discussed below, trustees are told that they cannot exercise their voting rights due to issues associated with splitting the vote, even though in certain cases, some fund managers have split the vote for select clients.

Given the transformation of regulatory and policy expectations regarding pension trustees' stewardship of pension fund assets, this refusal by the fund management industry represents an emerging governance gap that must be addressed. This report sets out to tackle this governance gap by exploring the barriers to split voting in pooled fund arrangements in the UK market. In doing so, it aims to set out practical solutions that can be developed to allow asset owners (pension funds), to meet their stewardship obligations.

1.1 BACKGROUND

In 2015, AMNT developed the Red Line Voting (RLV) initiative[14], an approach to help pension schemes become more active shareholders. RLV was inspired by the shareholder spring of 2012 when many fund managers told pension schemes invested in pooled fund structures that they could not vote on excessive pay awards. Red Line Voting set minimum expectations that pension schemes can apply to investee companies. The underlying idea was that trustees would have a strong basis to develop a voting policy for their schemes and fund managers would be required to follow these policies on a comply-or-explain basis. The AMNT liaised with the fund management industry to ensure that best-practice ESG frameworks, such as the UN Global Compact, were used in the development of the standard. However, most fund managers refused to accept Red Line Voting policies in pooled fund arrangements[15], which constituted nearly 50% of the assets under management in the UK at that time. The UK pension fund industry is very fragmented – for DB schemes there are 288 over £1billion, and 5143 that are less than £1billion[16]. Nearly all pension schemes invest in pooled funds, but the smaller the pension scheme the greater the amount of assets in pooled funds[17].

1.2 INTENDED AUDIENCE

The intended audience of this report is as follows:

Pension fund trustees and fund managers: Trustees are making investment decisions in a regulated environment that now puts effective stewardship at the heart of what trustees do. Consequently, pension fund trustees need to have the ability to hold sway on issues of ESG across all their investments, and not just across a subset where the voting chain is less opaque i.e. where pure ownership is present. By setting out with clarity the operational issues and challenges that asset owners face in effective stewardship, this report should form the basis of better conversations between trustees and those who provide asset management services.

Policymakers: The changes in the responsibilities and shifts in expectations as to what the fiduciary duties of pension fund trustees are regarding ESG and stewardship stem from the work of the Law Commission, which has been welcomed in government[18].

The direction of travel has therefore been set. However, achieving these regulatory objectives will only be possible in a world where trustees have the correct tools to be able to hold firms to account through voting and engagement. It is paramount that policymakers understand the challenges facing trustees and what barriers may be impeding them from achieving policy objectives and regulatory requirements.

[14] www.redlinevoting.org
[15] https://amnt.org/amnt-identifies-poor-transparency-in-fund-manager-voting-policies-and-practices/
[16] https://www.ppf.co.uk/sites/default/files/2020-01/Purple%20Book%202019.pdf
[17] https://www.pensions-expert.com/DB-Derisking/The-1bn-myth-how-scheme-level-costs-change-with-size
[18] https://www.gov.uk/government/consultations/pension-trustees-clarifying-and-strengthening-investment-duties

2.0 Research Methods and Process

The methodology for this research was a qualitative interview approach based on snowball sampling, which uses referrals and networks to access hard to reach populations. As the interviewees (pension fund trustees, fund managers, ESG experts, proxy voting firms, custodians) are experts in a specialised field, who often work for large corporations or institutions, they are, as a result, hard to reach[19].

A semi-structured interview protocol was used that covered the main areas of interest to understand the extent of the problem. The benefit of a semi-structured approach is that it allows the interview to evolve based on what is said during the interview, rather than rigidly conforming to a script that can restrict discussion.

As this is primary research, the semi-structured approach allows for a much deeper investigation of relevant issues than can be achieved through a large-scale survey. This method allows different views to be highlighted and the weight of prevailing views used to reach a general conclusion. Statements from earlier interviews can also be used in future interviews to further triangulate insight. Moreover, given the technicalities and complexities of split-voting in pooled funds, it would be almost impossible to develop a broad survey instrument that would allow for a rich set of findings. The time it would take to complete such a survey would inevitably mean that response rates would be too low for any meaningful insight.

Between May 2017 and February 2019, a total of 24 interviews was conducted. These were, where possible, conducted as face-to-face interviews. Where this was not possible, the interviews were conducted by telephone. The interviews ranged from around 45 mins to approximately 1.5 hours. Interviewees are non-attributable and so their title/specific role/employer are not mentioned in any quotations used to illustrate a position. As such, quote attribution for example could be 'Trustee, Large Pension Fund'. This allows the reader to understand something about the individual who has made the point e.g. their role and experience, but the individual is anonymised, and the quote is not directly attributable.

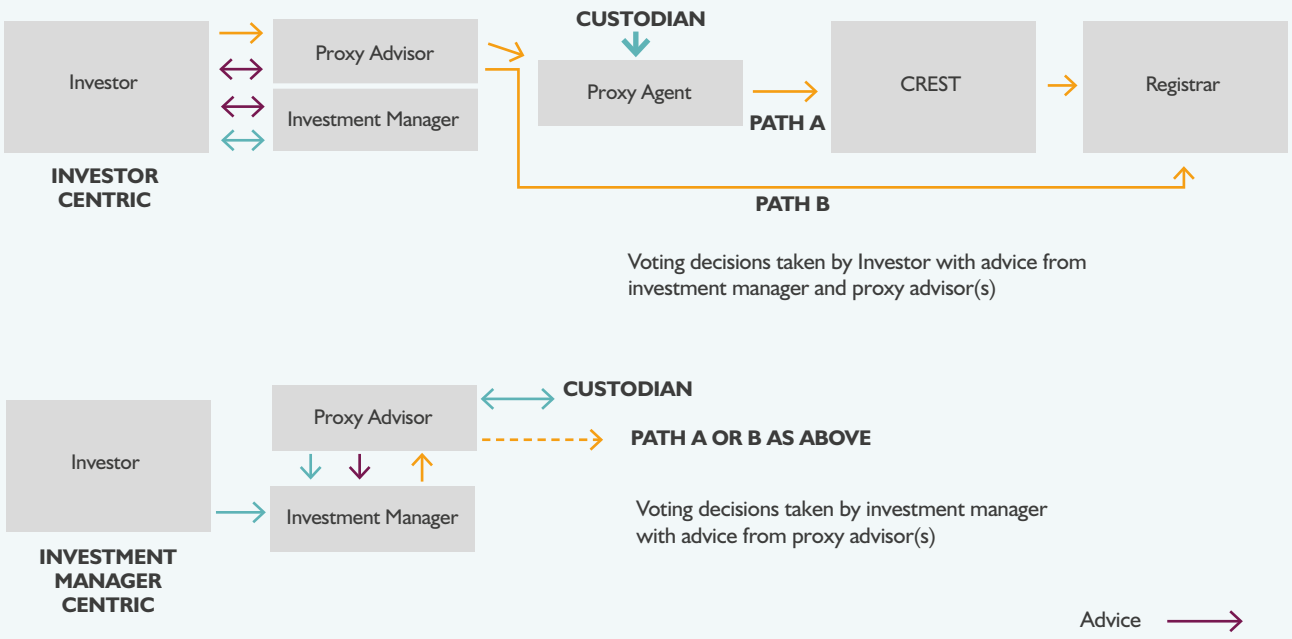
All interviewees were experienced investment professionals, pension scheme trustees, and professionals from across the voting chain. That said, the findings of this type of research are not going to be representative of the whole of the voting chain, nor will they be wholly reflective of specific parts of the chain. However, the evidence provided is believed to be robust and to reflect legitimate and genuine views from key actors in this sphere.

[19] This approach to understanding the institutional investor chain was also used by Business Innovation and Skills in their 2016 Report, Exploring the Intermediated Shareholding Model.

3.0 Description of Voting Process

This report does not undertake a forensic analysis of the voting system, but highlights those areas directly connected to the objectives of the report. Further detail on the complexities of the voting system can be found in the research completed by BEIS in this area[20] or indeed the Myners report[21]. This section will focus on a typical voting process, recognising that there are many combinations of intermediaries that can be used to ensure that the vote is received by the investee company. This process also aims to highlight the added complexity of voting in pooled funds whose assets are held by custodians in omnibus accounts.

The graphics below extracted from the 2016 BEIS report provide an example of a typical voting process[22].



We will consider an AGM as an example. The AGM meeting notice (ballot) is issued by a company and is sent to the legal shareholder (in the case of pooled funds – the fund manager) through a variety of means: by post, via a Central Securities Depository (CSD) electronically (in the UK – CREST) and notification on the company website. An electronic ballot is generally issued based on one owner, one ballot. Unless directed otherwise by their clients, assets are typically held by the custodian in an omnibus account. In this scenario, a single electronic ballot is produced and sent to all the intermediaries and the company registrar only sees a single owner, the omnibus account e.g., ABC Nominees (ABC is usually the name of the custodian). However, underlying this omnibus account are multiple fund managers who are not "seen" by the company. No matter how fund managers hold shares in the omnibus account, only a single ballot is sent.

The company registrar may also send the electronic ballot to a nominated voting service provider (VSP) e.g. Broadridge. The VSP will be sent a file from the custodian bank that sets out all the accounts that make up the number of shares in the account

[20] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/489357/bis-16-20-intermediated-shareholding-model.pdf
[21] http://www.shareholdercoalition.com/sites/default/files/Myners%20Report%201-04_0.pdf
[22] Source of diagram: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/489357/b is-16-20-intermediated-shareholding-model.pdf

e.g. 100,000 shares, and all the different fund managers that run those accounts. The VSP then sends a ballot on to these fund managers or to their proxy voting agent e.g. ISS. So, the single ballot has morphed into multiple ballots in a process distinct from that being run by the investee company.

The fund manager or proxy voting agent knows what part of the total 100,000 shares are "theirs" e.g., 20,000 shares and therefore 20,000 votes. Underlying the 20,000 shares in the pooled fund arrangement will be, for example, 5 or 10 pension funds that have provided the capital for the fund manager to buy these shares. All this detail and complexity is sitting between an individual investor in the pooled fund and the actual investee company.

> " All instructions flow through the chain, but it is generally the fund manager that is the stopping point, and they then vote the shares based upon whatever policy they choose"
>
> **Governance expert, large global fund manager**

Once the ballot is received, the investment and corporate governance teams begin reviewing the meeting materials to come to a voting decision. In a pooled fund, the fund manager will normally vote all shares in accordance with its own voting policy. However, if the fund manager were to accept client voting instructions within pooled fund arrangements, they would then need to split the vote when the client's instruction deviated from the fund manager's own policy.

Regarding the information that would be required to split the vote, this data would typically exist within the function of the fund manager's accountant for the pooled fund. As well as day-to-day activities such as the calculation of the net asset value of the fund, the fund accountant is responsible for recording all transactions (buys/sells) of securities and the outflows and inflows of the fund from redemptions and purchases, and the monitoring of capital gains and dividend distributions in the fund. As such, this data can be used to work out ownership and the pro-rata allocation of votes.

Once the votes are split across clients, the VSP's voting platform would allow fund managers to allocate their votes, for, against, and abstentions, in accordance with each individual client policy for AGMs in UK markets.

4.0 Reported barriers to split voting

This section of the report examines in detail the key challenges that are often presented as to why it is not possible to split the vote in pooled fund arrangements. It is important to examine each individually, as this builds up a comprehensive picture of actual challenges versus problems that are cited but are more of an 'excuse' than an impediment.

4.1 TECHNICAL BARRIERS

There are several technical issues surrounding the splitting of the vote in a pooled mandate with an omnibus account. A lack of technology and administrative rigour creates an opacity around who is the ultimate owner and how many votes are correctly attributable to a given pension fund. This is because systems are constructed on a "need to know basis" and not every link in the chain needs to know how many underlying owners there are in a pooled fund. This is a legacy systems issue and it typifies the challenges of a changing landscape: asset owners need to meet their stewardship obligations, but current systems are not designed to support this through the voting chain.

4.1.1 VOTING PROCEDURES

Depending on the individual voting arrangements of each shareholder, the process for voting can vary, with different combinations of intermediaries being used to achieve the same aim, and this is cited as a barrier to split voting. This has come about because of the ad hoc nature in which the system has evolved. A comment that was raised time and again by those involved in the voting chain, was that if the voting system were to be built today, nobody would build it as currently configured.

> "There is a huge diversity in approaches as to how people do things. And it is a classic example of how things evolve over time. Nobody if they were to sit down today and design the proxy system would have built what we have today."
>
> **Proxy advisor**

> "The medium of getting a proxy vote distributed from the end investor down the chain is a web of messy intermediaries handling and processing data from one intermediary to the next. It creates time delays, inconsistency in interpretation, data corruption, and a lack of transparency and extra expense."
>
> **Proxy voting expert, global asset manager**

Despite the diversity in approach, custodian banks have, for the most part appointed a single voting service provider (VSP), namely Broadridge. It is Broadridge who acts as a vote distributor and collector and is therefore an integral part of the voting infrastructure in the custody space.[23]

> "Custodians will say who is in the account, Broadridge will split the vote out, send to named agents/asset owners, get the votes back, reassemble, and submit to registrars. All issuers and registrars see is the consolidated numbers."
>
> **Custodian bank**

There are also time challenges associated with the UK voting process which has been cited as a barrier:

> "In the UK market there is a time challenge, and you get no more than two or three days to cast the vote. In the UK it is 14 days for EGMs and 21 days for AGMs for UK companies to be called. By the time they announce it, the registrar acts on behalf of the company and publishes the notice, the voting agents and custodians take 2 or 3 days to pick that up and code it, put it in their systems. It then appears in our systems but we're waiting on some background research to take place, that may take a week, by which time you're 4/5 days before your voting decision needs to take place. And you've got to make your decision and hope your clients are aware of it if you are telling your clients about it, and you've then got to read it, analyse it and get it back [the voting decision]"
>
> **Proxy voting expert, large global asset manager**

4.1.2 MANUAL INTERVENTION

For many fund managers it seems, the splitting of the vote, if it were to be done, would be a manual process. Given the extent to which sophisticated electronic systems exist globally for many more complex problems, to still be reliant on human input and intervention is a concern and speaks to a lack of investment in the voting infrastructure.

> "A further issue raised as preventing split voting is that the systems for managing custody and voting are not connected to a fund manager's fund accounting and administration systems. Therefore, it is a manual reconciliation process between custody and fund administration to determine what percentage allocation of a pooled fund an underlying client represents. This is because beneficial ownership information is not known to either the registrar or the custodian: only the fund administrator will be aware of these facts."
>
> **Proxy advisor**

Further, if there were to be a significant amount of manual input to undertake a reconciliation for the casting of votes to enable split voting, it is clearly an inefficient process. Moreover, given the tight deadlines that occur around voting, it might leave insufficient time for proper consideration of the voting issues, as there is valuable time wasted trying to understand who can vote.

[32] See for illustrative numbers on market share, The Broad Reach of Broadridge, The Most Important Financial Company You've Never Heard Of, Forbes, 2013.

However, Section 3.0 highlights the role that the fund accountant might have in splitting the vote. While there are more sophisticated whole-of-market solutions such as a unique immutable ID for each beneficial asset owner, which could allow for vote confirmation and look-through, the data held for distributions would appear to be a reasonable source of information on which, the vote could be split. This would streamline the process and reduce errors.

4.1.3 CONCLUDING REMARKS

It is clear there has been a severe lack of investment in the proxy voting system. It has not been a priority for much of the fund management industry, nor by extension, the custodian industry. It has been 14 years since the Myners Report[24] brought to light the many issues that existed in the voting chain and they are as relevant today as they were then. The reality today is that voting processes, built on legacy systems, are no longer fit for purpose given UK regulatory requirements. To allow for effective stewardship, there needs to be much more investment or innovation to the current system to engender real change.

> "Looking back 20 years ago from where we were to where we are now, there has been a dramatic lack of investment by custodian banks, by (voting) agents, by registrars, in the proxy voting plumbing, including electronic messaging and the transfer of data, it has not happened despite many of us lobbying for this. Broadridge sends a huge file to ISS, ISS sends a huge file to Broadridge and Broadridge sends an enormous file to the registrars. If this was a forex trade, if this was your bank account, or if this were anything else, I could tell you what went where, and who did it."
>
> **Proxy voting expert, large global asset manager**

Last, there are signs of innovation emerging. One potential source is the use of blockchain technologies. The hype around Bitcoin etc. has largely settled down, and what is left is a technology that is likely to have a wide variety of applications, including in stewardship.[25] Similarly, there are new platforms that are being developed such as Proxymity[26], that enables investors to vote in real time. However, it is too soon to be able to determine the direction of travel with respect to the development of solutions or what will ultimately change the current marketplace.

4.2 THE COSTS OF SPLITTING THE VOTE

> "It [splitting the vote] can be done but nobody wants to pay for it."
>
> **Governance expert, large global asset manager**

4.2.1 IMPLEMENTING A CUSTOM POLICY

Cost was cited as a barrier to split voting, especially as it relates to the manual process, which was often stated as requiring extra resource/investment to deal with different client voting policies.

> "If you'd come along with £10m in a pooled fund and asked for this, where we are today, then we'd [the industry] probably say no as it is just too complicated. Make that £100m and then we [the industry] would start to think about it and do something."
>
> **Proxy voting expert, large global asset manager**

[24] http://www.shareholdercoalition.com/sites/default/files/Myners%20Report%201-04_0.pdf
[25] https://www.unpri.org/sustainable-financial-system/responsible-investment-and-blockchain/2983.article
[26] https://www.citivelocity.com/proxymity/

On the issue of the costs of scheme-specific reporting as a barrier to split voting, there are services in the market which offer the type of reporting that trustees now need in this new regulatory environment (e.g., proxy advisors and voting and engagement overlay providers) which fund managers could commission to help service their clients' needs, and also ease their own reporting burden. However, the question of insufficient resourcing for increased reporting requirements speaks to a greater issue regarding underinvestment in the stewardship function, which is discussed in more detail in section 4.4.2.

4.2.2 CUSTODY ARRANGEMENTS

Custody arrangements that have developed over decades are also cited as a problem. Much of the structure that we see today, and the use of omnibus accounts, stems from allowing custodians to minimise costs.

> "A pooled nominee allows a custodian to minimise its costs. SWIFT and people like that charge per transaction. As a custodian of a pooled vehicle, you net everything off and only submit once for 100 or 1,000 or 1,000,000 clients."
>
> **Proxy voting firm**

> "It's all economically and cost driven. It costs a lot less to hold assets in an omnibus account. At each stage there is a fee and so someone is going to charge you."
>
> **Custodian bank**

> "If you look at proxy as a whole, it is not a competitive angle for custodians, they all outsource it. It's not really a competitive part of their offering."
>
> **Proxy voting expert, global asset manager**

There was no evidence presented throughout this study to suggest that split voting cannot be done in an omnibus account, and thus added costs do not necessarily need to be incurred. Interestingly, there was no answer provided as to what the order of magnitude in cost difference is between a designated and omnibus account. This may be a function of being 'put on the spot' in an interview, but does at the same time raise questions of cost transparency. If there is a significant cost difference that is a barrier, then this is fundamental to being able to understand the real cost of stewardship.

However, this example calls into question how significant these added costs are:

> A [large] client asked us about a Request for Proposal and we said do not go into a pooled account, you will lose control and will no longer be identifiable as you, and your relationship with the company will suffer as a consequence. They asked us 'What should we do?' The answer was simple. Ask for the price for a designated account and the price for a pooled account. If they want your business, then the price should be the same. So, they were able to use their buying power just by not being cowed into thinking the service provider was in control. They got a designated account.
>
> **Proxy voting firm**

In some circumstances, custodians may be prepared to absorb any extra "costs" associated with operating a designated account. Asset managers, and by extension their asset owner clients, therefore, may not have to pay extra for a designated account should they wish to switch. Whether this example represents a "one off" scenario for a large client or not, the request for a designated account at Request for Proposal (RfP) should, at a minimum, be a point of negotiation for the fund manager who is hiring the custodian or renegotiating their contract.

As previously stated, a fully designated account is not essential to be able to split the vote. However, assuming there are no added costs incurred, there are added advantages of having a designated account e.g. being visible in the casting of votes to investee companies. If additional costs are charged by the custodian, there are other workable solutions that have been identified e.g. in the Myners report that could be explored:

> "Custodians register the shares they hold on behalf of clients in one of three principal ways… in the name of a nominee company with a designation that can be unique and exclusive to each individual client, for example, XYZ Nominees Limited – AB Pension…"[27]

4.2.3 INTANGIBLE COSTS AND BENEFITS

In the context of splitting the vote, the issue is almost always referred to in purely monetary terms. However, there are other arguably more significant costs if voting is outsourced or ignored by pension trustees. In an index fund, whatever its type, it is not possible to divest from some companies and so engagement and voting is the only stewardship option. Given the trend towards low-cost index trackers, engagement becomes the sole stewardship tool for a growing percentage of the market.

> "While our active funds can sell a company if we disagree with its executives, our index funds cannot choose the shares in which they invest. We are essentially permanent capital and cannot turn the S&P 500 into the S&P 499." [28]

This is also true from the perspective of asset owners: this is about risk.

> "Some consultants will say that ESG doesn't generate alpha, well people buy life insurance, as you're going to die. ESG and governance is about beta, it is about whole market risk."
>
> **Proxy voting firm**

Another key risk that emerged in relation to why transparency in ownership in pooled vehicles is important concerns bankruptcy and property rights. In the types of pooled structures that are now common across UK institutional investment, there are concerns with respect to where asset owners stand in relation to other creditors if a fund management firm were to fail.

[27] http://www.shareholdercoalition.com/sites/default/files/Myners%20Report%201-04_0.pdf
[28] Source: Index Funds must be Activists to Serve Investors, Financial Times 24th July 2018.

> "People realised after Lehman's that it might be a bit dangerous not to be segregated. It was bizarre that they chose the options market to mandate the segregation of accounts. In fact, the judge said that nobody in their right mind would go into an omnibus position if they knew, and you say to people, do you want to rank pari passu with other creditors, or do you want your property back? Members' shares are property in UK law."
>
> **Proxy voting firm**

Last is the issue of visibility. In an omnibus account, even if voting were to be split further down the chain, asset owners would not be seen to be voting. For some funds, this visibility matters given the beneficiaries of their scheme, but it also matters as they want the management of the firm to know who it is that is voting against them on a specific issue.

> "What I would like is for the voting chain to give me visibility irrespective of what I invest in. If I vote against the chairman, then I want the chairman to know that I voted against them."
>
> **ESG specialist, large pension fund**

Moreover, in looking at the shift towards passive investment, voting is an increasingly necessary tool in ensuring effective stewardship.

> It is crucial to get your policy, your beliefs across. In some cases, it is your only voice as not all managers can engage across all companies which they are holding. If you hold the 920 companies in the UK market, then not all managers are going to engage with 920 boards, it is simply not feasible to do that.
>
> **Proxy voting expert, large global asset manager**

It has been suggested that split voting can be achieved as part of the tendering process. However, scale matters, and there was also an instance reported in an interview where the RfP requested a custom policy, and the asset manager agreed to this as part of winning the tender. However, afterwards, the asset manager refused to vote the custom policy due to increased costs.

> Red Line Voting was put into the RfP but once the mandate was awarded the asset manager said they don't vote Red Lines.
>
> **Trustee, medium sized pension scheme**

4.3 LEGAL ISSUES AND AUDIT RISK

In looking at the various barriers that have been identified, there are three that fall under the broad heading of legal issues. The first is who has the legal ownership of shares in omnibus accounts. Second and more importantly, is the argument that asset owners are buying units in the pooled fund rather than shares. Last, there is the risk that fund managers may incur through the manual splitting of the vote.

4.3.1 OMNIBUS ACCOUNTS

UK company meetings are conducted under the auspices of the Companies Act 2006 [29] and The Companies (Shareholders' Rights) Regulations 2009.[30] For the majority of investors in UK shares, the legal owner is a broker or custodian bank who keeps the shares in trust using a nominee name. If the asset owner had a segregated mandate in an omnibus account, then it would be classified as a "beneficial owner". However, within a **pooled fund** in an omnibus account, share ownership becomes opaque as set out below.

4.3.2 POOLED FUNDS - UNITS VS SHARES

One argument that has been used historically for voting residing with fund managers is that in a pooled fund, the pension fund buys units and the fund manager owns the shares. There are a range of perspectives on this, and across the interviews there was no consensus as to what the actual legal position is or the extent to which this is a substantive issue.

Cadbury in 1992 stated voting rights are "…an asset, and the use or otherwise of those rights by institutional shareholders is a subject of legitimate interest to those on whose behalf they invest" [31] and The Hampel Committee in 1998 recommended "…institutional investors of all kinds, wherever practicable, to vote all the shares under their control, according to their own best judgement, unless a client has given contrary instructions".[32]

While there is no definitive law, rule, or regulation that gives genuine clarity to this issue, there are examples where the vote has been split in a pooled vehicle in the UK.

> "The barriers aren't legal or technical, it is just a willingness to do it…one asset manager made a concession fairly early on, and we could direct our UK voting.[33]"
>
> **Head of governance, large pension fund**

Contrary to this ambiguous position on who holds the votes, the regulatory and fiduciary position for trustees is that they should be effective stewards of the assets in which they are invested. This empowers trustees to develop voting policies should they wish to do so, and this is especially important on issues such as climate change, if climate related risks are deemed to be financially material to their investment strategy.

4.3.3 AUDIT RISK

One argument used for not splitting the vote is that there is too much operational risk inherent in the process of splitting the vote. The fragmented systems and lack of investment in the voting infrastructure means that there is an undue amount of human input into what should ultimately be an automated process given modern IT systems.

[29] https://www.legislation.gov.uk/ukpga/2006/46/part/13/chapter/3 29https://www.legislation.gov.uk/uksi/2009/1632/contents/made
[30] https://www.legislation.gov.uk/uksi/2009/1632/contents/made
[31] The Cadbury Report, 1992, para (6.12).
[32] The Hampel Committee (1998) para (5.7).
[33] This quote is in relation to a pooled passive index tracker.

> "We do this [split the vote] for a very small number of legacy clients…so on a monthly basis we look at the units that each client holds and work out as a percentage how much those clients hold as a rough percentage of the overall fund, which works out at X% and the vote is split out for them and the rest of the fund follows our policy. What we then do, and it is a manual process, is we take in Excel sheets, pdfs, that come from their proxy advisor, we'll then put that into a simple sort of spreadsheet that keeps the percentages of client a, b, c, d, we apply that vote to it, and then it looks at our overall record date position and then gives us what that clients percentage holding of that unit represents, in terms of nominal, and then someone has to individually go into the ISS platform and split that out by resolution."
>
> **Proxy voting expert, large global fund manager**

The consequence of this is that the manual splitting of the vote carries with it the risk that there is human error in this process. It is therefore possible that as a result of human error, the level of ownership attributed to a pension fund for whom the vote is being split is too high/low.

> "It is very manual. There is a risk to it and we take on a risk for the other X% of unit holders in the fund because there is a bit of an issue if you trade around the record date as well, as it can confuse the overall holding position, as you're voting a position where it technically could change tomorrow, and if that happens you have to go in and re-vote it…we can't split the vote by percentage on the ISS platform although that is going to be changing, so if there is a sale trade around the record date then we have to re-vote it all…even if it is just one share out, and that is where the risk lies."
>
> **Proxy voting expert, large global fund manager**

As a result, the votes cast may over/understate the holdings of the pension fund and therefore skew the vote. This is not good for effective stewardship nor is it good from an operational risk perspective of the fund manager, who would ultimately be responsible for the incorrect splitting of the vote.

4.3.4 CONCLUDING REMARKS

A forensic analysis of the legal barriers to share ownership, such as highlighted above with respect to units versus shares, are not for this report. However, it is important to note that there is evidence of some fund managers splitting the vote for select clients. The question is therefore not one of legal barriers as this is already happening in practice.

The position that there is an inherent risk to a manual process introducing error is one that cannot be disputed. From an operational perspective, to be cautious where liability may be incurred is prudent. However, this risk is a function of underinvestment and the fragmented structure of the voting chain.

If there were to be better systems, this would serve two purposes. First, there would be greater accountability and transparency around issues of stewardship, even where votes are not being split. Second, it would allow the splitting of the vote to be carried out more efficiently. This would give asset owners the option for their votes to be separated out, in a regulatory environment that is placing increasing amounts of emphasis on trustees being better and more engaged stewards.

4.4 CULTURAL AND BEHAVIOURAL BARRIERS

The aim of this section is to discuss some of the cultural and behavioural barriers (historic and current) that exist in the market. Many of the non-technical issues that are barriers to change emerge from this complex context. However, it is this context that is often not discussed with balance, and there is a circularity in the arguments as to why change is not possible.

4.4.1 TRUSTEES

In discussions about the lack of involvement by pension scheme trustees in the development of ESG policies, an oft-repeated stance has been to blame the trustees for lack of interest. This is a simplistic view that is damaging to any potential progress in this area and fails to understand the environment in which trustees operate.

First, such a view fails to distinguish between the trustees of large schemes which, in the main, have sophisticated policies sometimes operated by in-house Responsible Investment (RI) teams. This clearly removes the need for such services from fund managers. However, smaller schemes, may not have any in-house personnel for any aspect of the management of the scheme let alone RI teams.

Second, it overlooks the reality of trusteeship, and the regulations and guidance that trustees are required to follow. Until relatively recently, there has been no meaningful regulatory requirement in relation to stewardship. All trustees are expected to complete the Pension Regulator's Trustee Toolkit, but this has little on ESG and RI.

More importantly, while there are many trustees that could be described as disengaged, what is lost in this view of trustees as a homogenous group is the reasons for this disengagement, and the fact that many trustees recognising their financial materiality are in fact engaged in issues of ESG and stewardship. Despite this engagement, these trustees face considerable barriers to trying to meet the expectations that regulation places upon them.

THE ROLE OF INVESTMENT CONSULTANTS

A concern raised by trustees was that even when investment consultancies had very high quality ESG policies at the corporate level, this did not always reach the trustee board via the consultants in the field.

> "When I raised ESG and voting with my investment consultants they dismissed the idea as not being relevant to the fund."
>
> **Trustee, medium sized pension scheme**

There have also been questions as to the capacity of investment consultants to genuinely support trustees around such issues.

As stated by the EU's High-Level Expert Group on Sustainable Finance,

> "In consultant/intermediary-led markets, the governance arrangements of pension funds can be a barrier. Since the members of governing bodies are often not financial specialists, reliance is placed on specialist financial advisers and outsourced investment managers. There is a question over the relevant competencies of investment consultants' field staff, which may be very separate and disconnected from 'responsible investment' specialists at the consultant".[34]

[43] High Level Expert Group on Sustainable Finance, Final Report, January 2018. https://ec.europa.eu/info/publications/180131-sustainable-finance-report_en

It has been widely recognised that many investment consultants do not in the main have a track record of proactively raising stewardship matters with their clients. Indeed, it was reported in relation to small funds that the investment consultant's advice was to delegate all stewardship matters to the fund managers.

> "I asked our investment consultant during the trustee board meeting about drawing up a voting policy, and he replied that our scheme was too small and we invested in pooled funds so it wasn't relevant to our scheme and we should leave it all to the fund manager."
>
> **Trustee, small pension scheme**

Trustees are required to have regard to the advice of their advisers, and trustees should be prepared to challenge their advisers when necessary. However, on a major issue regarding effective oversight of their investments, an attempt to challenge and overturn consultants' advice to delegate to their fund managers is a major undertaking on the part of the trustee or the trustee board.

EVIDENCE OF DEMAND-SIDE PRESSURES FROM TRUSTEES

As well as individuals who are engaged in the process of stewardship, there have been shifts in demand for the structures, processes, and support that trustees need to be effective stewards. The first example of this is arguably the AMNT's Red Line Voting initiative, which was developed at the time in what appeared to be the absence of such policies from investment consultants.

Recently, the AMNT and the UK Sustainable Investment and Finance Association (UKSIF) secured the public commitment of 16 investment consultants, representing approximately 85% of the market, to ensure that they brought the new TPR investment guidance to the attention of their trustee clients.

This is a crucial shift in approach, as investment consultants have a responsibility to ensure that their clients adhere to the requirements of the legislation and the expectations of the Pensions Regulator, which now includes ESG considerations.

HISTORICAL CONSTRAINTS ON TRUSTEES IN THE CURRENT MARKET ENVIRONMENT

Trustees for whom stewardship was a priority, in the face of no support from the Pensions Regulator (prior to the more recent regulatory changes), fund managers and the investment consultants, found themselves having to: a) persuade their own fellow trustee board members; b) raise it at board level with their consultants and in some cases in opposition to the consultant; and c) challenge their fund managers.

This reality was, and may well remain, a major contributing factor to the lack of engagement of trustees on ESG and stewardship. For those trustees that are cynical about stewardship and its value, or are unaware of its importance, there is little to no chance that this view can be altered, if there is no consultant and fund manager advocacy for the fundamental role that ESG and stewardship have.

4.4.2 FUND MANAGERS

STEWARDSHIP AS A SOURCE OF COMPETITIVE ADVANTAGE

Many of the interviewees from the fund management industry who are champions of stewardship would like to see it become a source of competitive advantage.

> "I'd like to see a market in this. If this becomes a differentiating factor that attracted and retained clients, then we would resource this as well."
>
> **Governance expert, large global fund manager**

Moreover, these individuals are advocates for building up better relations between the stewardship side of the fund management industry and asset owners. That said, there is an acknowledgement of the challenges inherent in trying to shift their organisation and the industry. While these people are a force for good in trying to improve stewardship in the industry and see the potential for a market and source of competitive advantage based on expertise in stewardship, this view does have issues attached to it.

For example, AMNT's recent report on the voting policies and practices of fund managers showed 42 fund managers had ambiguous and opaque voting policies and guidelines on climate change, gender, and ethnic diversity, in their publicly available policy statements e.g. 20 major fund managers failed to even mention climate change in their voting policies. ShareAction's recent report[35] on asset manager response to climate change shareholder resolutions also showed a very mixed voting pattern with variable levels of support for proposed climate resolutions[36].

For a market to develop in stewardship, not only do fund managers need to develop more robust voting policies on key ESG issues (as evidenced by AMNT's study), but greater transparency and better client reporting is also required. Asset owners need to be able to benchmark their fund managers voting policies to effectively hold them to account for their stewardship approach. To accomplish this, fund managers need to be more transparent about their own policies, including voting guidelines, but also report against their clients' policies and explain why they voted in ways which do not align with client views on ESG issues.

Notwithstanding these findings, the argument for a 'market' in stewardship does not, in any case, address the fundamental issue that faces trustees, namely, being effective stewards of investments that they make on behalf of members. Moreover, given the current landscape, there is no common baseline for a market to develop. In other words, the ability of trustees to exercise their votes to be effective stewards, nor even to have their voting policies accepted by fund managers on a comply or explain basis, is not present.

An unintended consequence of fund managers seeking competitive advantage through better stewardship expertise than their competitors, is that this could work against the engaged institutional investor. Trustees have reported being told that the fund manager will not accept trustee voting policies as they wish to vote all "their" shares the same way to have a more powerful voice. However, there is a question as to whether this "powerful voice" is always in alignment with the long-term objectives of the trustees and any policies they develop to meet their regulatory duties.

Intentionally or not, it also places the emphasis on the fund managers' expertise in this area, versus a collaborative approach, where fund managers and asset owners work together to achieve the latter's stewardship objectives that are specific to their fund. In addition, stewardship as a "brand offering" also may distract from the key systemic issues that need to be resolved, such as updating structural requirements for effective stewardship e.g. the voting infrastructure.

It is also crucial to differentiate between ESG and voting. Voting is a part of the stewardship and governance toolkit for holding corporate management to account. This is especially important, when voice, as opposed to exit, is seen as playing a fundamental role in long-term investors as effective stewards. Moreover, allowing asset owners to develop their own policies does not diminish or reduce the expertise of ESG functions within asset managers. In fact, it may require more of their expertise to cover a wider range of issues to ensure appropriate engagement and explanation where deviations from a client policy occur.

[35] https://amnt.org/amnt-identifies-poor-transparency-in-fund-manager-voting-policies-and-practices/
[36] https://shareaction.org/wp-content/uploads/2019/11/Voting-Matters.pdf

Given the complexities involved, further industry discussion is warranted on the issue of achieving a "market in stewardship" and what this would mean in practice to ensure that:

> Any market solution places asset owners at the heart of the stewardship agenda, thereby allowing them to fulfil their fiduciary duty rather than being sold a stewardship product i.e. a 'one-size-fits-all' approach.

> It addresses in the first instance the systemic issues that are barriers to effective stewardship (e.g. voting infrastructure issues, accepting client policies etc).

UNDERINVESTMENT IN THE STEWARDSHIP FUNCTION

There are many stewardship experts in fund management firms, and many who would describe themselves as 'veterans of the industry' regarding stewardship and ESG in fund management. However, for many of those involved in the industry more broadly, stewardship has simply not been a priority. Historically, there was no money in votes.

The consequence of this was that there were few or no incentives to be innovative in this space, and due to the sporadic demand for innovation from asset owners, it was easy to ignore in all, but a few select cases. For those funds where an exception was made, the rationale for allowing a different arrangement was simple – scale. Large pension funds have reaped the benefits of this arrangement in many ways e.g. the ability to split the vote in pooled fund structures.

> "[Size] does make a difference, our firepower is a lot greater than many schemes."
>
> **Head of governance, large pension fund**

While notable advances in stewardship been made, there is arguably a long way to go before it is truly embedded. Moreover, there are many ways to invest in this resource i.e. there is no "one size fits all" approach.

Historically, one of the most common ways the fund management industry has invested in this area is through the creation of dedicated stewardship teams. However, even in the largest fund managers, stewardship teams are small.

> "I mean upstairs there are thirty odd [financial] analysts, and for governance, it's around three. Why is that? It's because we don't make a lot of money doing governance".
>
> **Governance expert, large global fund manager**

A recent study[37] from Willis Towers Watson (WTW) seems to broadly support this view. WTW stated that "while it is encouraging to see that the majority of firms have increased internal stewardship resources over time, this upward trend is less obvious when compared to total firms' assets under management, and compared to the total number of investment professionals employed". With regards to passive management stewardship teams, and the enormous task that engaging with 10,000 companies entails, WTW stated that the "practical task list alone necessitates for bigger teams and the value proposition further justifies increased resourcing". "If just a quarter of a basis point – often merely a rounding error – of every asset invested was directed to stewardship, that could mean teams of orders of magnitude bigger than at present (estimated to be 10 times bigger on average)".

The size, visibility, and embeddedness of stewardship teams is highlighted in areas such as Requests for Proposal. It is uncommon for representation from the stewardship side of the business to be involved in the 'beauty parade'. Those pitching will often refer to a stewardship team, but it is disconnected, by virtue of those involved in stewardship not being involved in the pitch.

[37] https://www.willistowerswatson.com/en-GB/Insights/2019/04/investor-stewardship-one-hand-on-the-wheel

> We asked during the beauty parade whether they would accept Red Line Voting and they said they would check with their governance people. Later we were told that their team takes into account the Red Lines when deciding the fund manager's voting policy for the year. I found that hard to believe since the voting policy didn't even mention climate change.
>
> **Pension scheme trustee**

The signal is therefore one that is mixed. There is greater investment in stewardship expertise than 10 years ago, but it remains insufficient, and these specialists are still not front and centre in the fund management process. If stewardship were truly seen as a way to identify, assess, and mitigate risk, ESG and stewardship teams would have a higher profile in trying to secure business for the fund manager. In other key aspects of the tendering process, there is no waiting for a request from asset owners i.e. a core part of any pitch is the ability of fund managers to manage risk.

4.4.3 THE BYSTANDER EFFECT

The parallels between the lack of engagement from both asset owners and asset managers are somewhat telling. It has parallels to a psycho-social phenomenon called the bystander effect. Here, individuals are less likely to offer help to a victim when other people are present. The greater the number of bystanders, the less likely any one of them will offer to help. There are several factors that contribute to this; ambiguity, cohesiveness, and diffusion of responsibility, all of which reinforces mutual denial of a situation's severity.

In the case of "lack of client demand" being used by the fund management industry as a case to support the status quo, the problem ends up as a vicious circle. Trustees do not sufficiently hold fund managers to account for their voting activities. Further, investment consultants have not sufficiently engaged with trustees on ESG and stewardship issues in the past, nor more specifically, put pressure on the fund management industry to implement client voting policies [38]. This exacerbates the trustee inertia problem, as it discourages those trustees that might be interested but need guidance and support, and consequently confirms the pre-existing belief some trustees have that ESG and stewardship is not of concern to them. As a result of this lack of signalling from the trustees and the investment consultant industry acting on their behalf, fund managers do not see there being sufficient demand, nor do they adequately report how their voting activities have added value. The result being underinvestment in systems and infrastructure, as demand appears to be the provision of a bespoke service for a handful of clients.

4.4.4 CONCLUDING REMARKS

The current state of voting and the objectives, experiences, and views of the key intermediaries in the chain create a situation where responsibility is diffuse and so positive change is hard to achieve. A historical lack of engagement by all parties has resulted in the evolution of the ownerless corporation and the responsibility of stewardship is not one that the asset management industry ever asked for or is equipped to deliver on (Myners, 2018).[39]

In looking at trustees there are two issues. First, there are those trustees that are not engaged in issues of stewardship. These trustees are a barrier to change and to effective stewardship. Moreover, as the regulatory landscape changes and ever greater expectations are placed on trustees to be active stewards, they are likely to find themselves significantly behind where they need to be to effectively discharge the fiduciary duties placed upon them. Second, there are those trustees that are engaged. These trustees are faced not only with getting stewardship issues onto the agenda at the trustee board level but are also faced with uphill struggles. A historic lack of engagement on the part of investment consultants, the opposition of fund managers to splitting the vote, in all but a few select cases, and out-of-date infrastructure serve as a rationale and basis for not improving the situation today.

While there is an increasing emphasis on stewardship in fund management firms, there is a need for the industry more broadly to recognise the new regulatory framework under which trustees are now operating. To serve the end client's needs in this new regime, fund managers will have to modify their business models. Specifically, this means that fund managers will have to have greater flexibility in their approach to stewardship and they must accommodate the different needs of different pension funds and their trustees, as there will not be a one-size-fits-all solution i.e. some funds will engage with the fund manager's policy and use that, while others will wish to have the fund managers operate the voting policy, as designed by the trustees of the scheme, on a comply or explain basis, while still others will wish to vote and be seen to vote their own policy.

[38] As a result of this dynamic, AMNT and UKSIF produced a trustee guide to holding consultants to account for the quality of their ESG advice. The report can be found on here: https://amnt.org/holding-investment- consultants-to-account-a-guide-for-trustees/

[39] Institute and Faculty of Actuaries, Autumn Lecture 2018, https://www.youtube.com/watch?v=9nYJExU9Tn4

5.0 Conclusions and Recommendations

The findings of this report result in three overarching conclusions as follows:

- The barriers presented to split voting in pooled funds are not insurmountable, especially as some fund managers have already been doing this for some clients. Put simply, asset owners' policies could be implemented by fund managers if there was the will to do so.
- Whilst a lack of will represents a key driver for inertia in addressing the issue, long-term underinvestment in the voting system means that it is no longer fit for purpose. The voting system needs urgent reform. There needs to be a simplification of the voting chain and investment in technology to enable the effective stewardship of pension fund investments for the long-run.
- While asset owners need to be more proactive in their stewardship approach, they cannot do so without the support of their fund managers and investment consultants.

Recommendations for future action are discussed below and divided into short and long-term objectives. Given the complexity of the issue, a range of solutions are required to affect real change in this area.

SHORT TERM

FUND MANAGERS

There are specific areas within the new Stewardship Code which, if implemented by fund managers in the spirit as well as the letter, would go far to resolve this issue.

Under the new Code, fund managers should:

- **Explain how assets have been managed in alignment with clients' investment and stewardship policies (Principle 6, activity).**
- **Explain where they have not managed assets in alignment with clients' investment and stewardship policies, and the reason for this (Principle 6, outcomes).**
- **For listed equity assets, disclose their policy on allowing clients to direct voting in pooled accounts (Principle 12, context).**
- **Demonstrate that their governance, resources, and incentives support stewardship (Principle 2).**

The requirement to explain how assets have been managed in alignment with clients' policies, as highlighted in bold above, is key. However, the power of this reporting requirement is only as great as the willingness of the fund management industry to cooperate on this issue.

In fulfilment of the Stewardship Code, fund managers should also report how aligned their own "house" voting policies, including voting outcomes, are with their clients' policies.

The advantage of this would be that reporting would be on the asset owners' policy rather than that of the fund managers. Currently, if a fund manager chooses not to have a policy on an ESG issue, or not to engage or vote on it, they may omit any mention of it in their current reports. By reporting against trustee policies, it would become much easier for trustees to understand how fund managers are fulfilling the policies that the trustees consider important. This approach would also make it easier for fund managers to see where their policies differ from those of their clients. For example, if an asset owner has adopted the AMNT's Red Line Voting policies, they would have a clear policy on climate change and the necessity to work to limit global warming to below 2 degrees. Any fund manager whose voting policies did not mention climate change would therefore have to justify that.

Having such an approach to reporting would bring greater accountability and should provoke far more effective and efficient discussion on stewardship between fund managers and their clients. Since fund managers would have to report against the client's policy, and many pension schemes have several fund managers, this approach would enable the client to compare fund managers with each other on a like-for-like basis. Such a change would represent a significant shift in accountability and transparency on this key issue. As such, it might begin to create competition across fund managers on issues of stewardship and their ability to deliver this, as trustees would be able to make comparisons across funds. Whilst this does not address the focus of this report on split-voting in pooled funds, this does at least advance the issue of potential misalignment between asset owners and fund managers.

ASSET OWNERS

The UK regulatory signalling is clear for trustees on the matter of stewardship – asset owners must develop policies on ESG issues that they consider to be financially material in their investments. Whilst there may be flexibility as to the content of that policy i.e. whether the policy is to be directly implemented by fund managers or used as a benchmarking tool to evaluate/compare fund managers, trustees must have a policy on any ESG issues they consider financially material. Asset owners can no longer outsource their stewardship responsibilities to fund managers with no oversight.

For those trustees that wish to have their voting policies directly implemented by their fund managers, they should write to their potential and existing fund managers asking how they plan to adhere to the new Stewardship Code requirements described above (most notably those in bold). In addition, trustees should also conduct a benchmarking analysis of their voting policies against that of their fund managers. The formal feedback received from the fund managers on these issues should inform the trustees' fund manager selection, appointment, and ongoing monitoring processes with investment consultants supporting trustees in this endeavour.

Trustees should also write to their investment consultants asking how they plan on supporting them in their efforts to have their voting policies implemented, citing the new Stewardship Code reporting requirements.

Trustees are can also use resources such as the AMNT's trustee guide[40] to help in holding their investment consultants to account for the quality of their ESG advice. If the quality of the advice is not meeting trustee expectations and they are not getting the support they need in this regulatory environment, consideration should be given to switching advisors, who can better support them in meeting their regulatory obligations.

[40] https://amnt.org/holding-investment-consultants-to-account-a-guide-for-trustees/

INVESTMENT CONSULTANTS

Investment consultants have a crucial role as gatekeepers between asset owners and the fund management industry. Therefore, they have an important responsibility to not only serve their asset owner clients' individual best interests as highlighted in the previous section, but to also address barriers that impede asset owners' ability to exercise their stewardship responsibilities. As such, this would include supporting trustees in the following ways:

- **Development of their stewardship and ESG policies as per regulatory requirements. The emphasis should be on the provision of tailored advice to trustees on policy development, versus a consultants' standard policy. This avoids asset owners outsourcing and delegating their stewardship responsibilities to investment consultants.**
- **Having their voting policies implemented by their fund managers, should that be the way in which a trustee board wants to meet their stewardship obligations. Put simply, investment consultants should hold any fund manager to account for their unwillingness to accept client voting policies. In practical terms, this means the unwillingness of any fund manager to accept client voting policies should be reflected in the investment consultant's fund manager rating system. This could include the downgrading of a fund manager depending on the internal process for fund manager evaluation on stewardship/ESG considerations.**

More broadly, investment consultants should sign up to the Stewardship Code for service providers. They should be held to account by their clients both for doing so, and for the quality of their delivery. In the context of this study, the following elements of the Stewardship Code are of relevance for investment consultants, and if signatories they should:

- **Disclose an assessment of how effective they have been in serving the best interests of clients (Principle 1, Outcome)**
- **Identify and manage conflicts of interest and put the best interests of clients first (Principle 3 – All)**
- **Explain how their services best support clients' stewardship (Principle 5, Activity)**
- **Explain how they have taken account of clients' views and feedback in the provision of their services (Principle 5, Outcome)**
- **Identify and respond to market-wide and systemic risks to promote a well- functioning financial system (Principle 4 – All)**

CUSTODIAL ARRANGEMENTS – DESIGNATED VERSUS OMNIBUS ACCOUNTS

The report also identified concerns regarding whether there are actual cost differences between operating a designated versus an omnibus account.

If asset owners were able to switch to designated accounts within a pooled fund mandate, whilst this wouldn't entirely solve the problem at hand, it would help to better identify individual clients within the pooled funds, and thus obtain more accurate vote splitting. It would also help to achieve greater end-to-end vote transparency and help to provide confirmation that the votes had been properly cast.

The FCA recently identified omnibus accounts as being a barrier to effective stewardship in its October 2019 feedback on building a regulatory framework for effective stewardship[41], and the Law Commission is investigating the legal position around some of these issues. Given this, the suggestion that designated accounts should be used to improve transparency in ownership is not out of line with ongoing policy debates.

[41] https://www.fca.org.uk/publication/feedback/fs19-7.pdf

MEDIUM TO LONG TERM: THE NEED FOR AN INDUSTRY WORKING GROUP WITH SUPPORT FROM REGULATORY BODIES

There are many challenges presented in this report that cannot simply be resolved through contractual arrangements between the asset owner and the fund manager, and that require the industry (notably asset owners, fund managers, and investment consultants) to come together to develop solutions.

Given that these challenges can be viewed as a form of market failure, the most effective and practical way forward is the creation of a government-led working group to address:

The overly complex and archaic voting infrastructure. Addressing this issue will not only go a long way to tackling the technological barriers highlighted by the industry to splitting the vote but will also have additional benefits e.g. vote confirmation.

Underinvestment in the stewardship function in fund management. Fund managers need to adjust their business models to reflect the new regulatory requirements of their asset owner clients. It can no longer be a legitimate position for a fund manager to simply cite lack of investment, in whatever form that might be e.g., dedicated RI staff, training for portfolio managers on ESG issues etc. as a reason for maintaining the status quo of not implementing client policies.

Transparency of voting policies and outcomes. Fund managers do not, on balance, provide enough information in their public voting policies such that asset owners can effectively benchmark the fund managers policies against their own, and if needed, challenge the fund manager. The FCA's commitment to evaluating the voting policies of fund managers, as outlined in their discussion document on the effectiveness of stewardship, suggests that how things stand is no longer acceptable.[42]

Scheme-specific reporting requirements. It is important that trustees drive the reporting content that they need to be effective fiduciaries. With tailored and specific information, trustees can demonstrate how they are meeting their obligations and can hold their fund managers and through them investee companies to account in instances where there is significant disagreement on an issue. Such information will also allow for trustees to benchmark asset managers and therefore allow asset managers to demonstrate their expertise and leadership on ESG issues.

The working group should be led by the DWP and be balanced such that asset owners from a range of small, medium, and large schemes are included, with the rest of the working group being comprised of all parts of the voting chain, including issuers as well as regulatory representatives. Crucially, the composition of the panel should ensure a majority voice is given to asset owners. Given the array of fund managers and intermediaries involved, it would be easy for representation to skew to over-representation of asset managers and intermediaries. However, what is crucial in all of this is that any working group convened would be able to develop a market-based consensus driven solution, with regulation being considered only as a last resort.

In conclusion, given that the barriers identified in this report are not insurmountable, action needs to be taken now in this regulatory climate to address the impasse that exists between the fund management industry and its asset owner clients. Issues such as the climate emergency put even more pressure on the stewardship chain to ensure that beneficiaries long-term interests are protected. With the support of policy makers, it is hoped that this report forms the basis for a constructive dialogue between fund managers, investment consultants, and their asset owner clients, as well as the rest of the voting chain, to develop practical and actionable solutions to this fundamental issue.

[42] As noted at the start of the report, the recent FCA workshop in February 2020, Aligning Stewardship Objectives Across the Institutional Investment Community, is indicative of the significant shifts and change in direction in this area.

Glossary

This glossary serves two purposes. First, for those who are not well versed in the terminology, which can often be confusing it should aid in understanding the issues as set out below. Second, it provides clarity and consistency for the above analysis. The glossary is divided into three sections: investment, voting infrastructure, as well as ESG and stewardship.

INVESTMENT

Beneficiary

The person with the ultimate economic interest in investment securities, at the end of an intermediated securities chain. For the purpose of this report, a beneficiary may be an individual or an institution holding securities on its own behalf.

Fund manager

An individual (or organisation) to whom the responsibility for the day-to-day management of the scheme's assets is delegated. The fund manager will act on the basis of instructions given to them by the client in the investment mandate.

Custodian

An institution that is responsible for the administration and safekeeping of assets that belong to another party and typically administer matters such as the collection of dividends and coupons. Assets are usually held in two types of accounts:

OMNIBUS ACCOUNT

Accounts which are used to hold the securities of more than one investor in one place (in contrast to "segregated or designated accounts"). This is also is referred to as a pooled account but for the purpose of this report, the term "omnibus account" will be used to avoid confusion with pooled mandates (see below).

DESIGNATED ACCOUNT

Accounts which only hold the assets of a particular investor (in contrast to pooled or omnibus accounts).

Investment mandate

An investment mandate is the terms between a pension fund and an investment manager that sets out the way in which a pension fund's assets are to be managed. For example, a mandate may set out particular sectors or geographies, have a target return on the investment for a specified level of risk, and may restrict particular investments. As it relates to the purpose of this report, there are two main types of mandates:

SEGREGATED MANDATES

A segregated mandate is an investment portfolio which is constructed to the pension fund's own investment guidelines.

POOLED MANDATES/POOLED FUNDS

A pooled mandate is an investment vehicle that allows investors to pool their assets and invest together. Investors in pooled vehicles tend to benefit from economies of scale and are able to diversify their investments more easily.

Financial intermediary

The investment chain is a complex system of different actors including custodians, investment managers, brokers, etc. Any actor that forms part of the chain can be referred to as a financial intermediary.

VOTING INFRASTRUCTURE

Registrar

The registrar is a company that manages the register of shareholders on behalf of issuers (companies). The registrar is responsible for the communications that relate to the management of the shareholdings of investors e.g. dividend payments. In addition, the registrar also manages the voting process for general meetings on behalf of the issuer.

Central securities depository ("CSD")

An electronic register on which securities are registered. CREST is the central securities depository in the United Kingdom.

Proxy voting advisors

For the purpose of this report, a proxy voting advisor ("proxy advisor") is a company hired by the fund manager to recommend how the votes of the pension fund should be cast and, in some instances, to also cast the votes.

Proxy voting agents

Proxy voting agents manage the infrastructure and architecture of the voting process that custodians and investors use.

SWIFT

The Society for Worldwide Interbank Financial Telecommunication (SWIFT) provides a network that enables financial institutions worldwide to send and receive information about financial transactions in a secure, standardised and reliable environment. Within the context of this report, SWIFT is the system by which votes are transmitted to the company registrars.

ESG AND STEWARDSHIP

ESG

Environmental, social, and governance factors are a set of indicators that are used to assess the performance of companies and are often used to assess the future financial performance and long-run sustainability of a company.

Stewardship

Stewardship is an approach to investment that aims to protect and enhance the value of an investment that accrues to an ultimate investor by promoting actions and behaviours in investee firms that should lead to the long-run success of the firm. Such activities include, but are not limited to, engagement on corporate strategy, risk, capital structure, and aspects of governance such as executive compensation and culture.

Shareholder engagement

Shareholder engagement is typified by the voice approach to governance. As such, it emphases dialogue and discussion between shareholders and their agents, and the management of their investee companies around issues such as performance, strategy, board composition etc. See stewardship.

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