

Pension Fund Committee

Meeting to be held on 29 November 2013

Electoral Division affected: 'All'

Shareholder Voting, Engagement, and Fiduciary Duty

(Appendices 'A' and 'B' refer)

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Executive Summary

In accordance with its policies on promoting corporate social responsibility in the businesses in which it invest the Fund works through Pensions and Investment Research Consultants Ltd (PIRC) as its Governance Adviser and the Local Authority Pension Fund Forum (LAPFF) to both ensure that shares are voted in accordance with sound governance principles and influence companies' behaviour.

This report provides the latest quarterly update for the Committee on the work undertaken on the Fund's behalf by PIRC and the engagement activity undertaken by LAPFF.

The attached report from PIRC (Appendix 'A') covers the period 1 July to 30 September 2013. The Fund has voted on 392 occasions and has opposed or abstained in 36% of votes. PIRC recommends not supporting resolutions where it does not believe best governance practice is being applied. PIRC's focus has been on promoting independent representation on company boards, separating the roles of CEO and Chairman and ensuring remuneration proposals are aligned with shareholders' interests.

The attached engagement report from LAPFF (Appendix 'B') also covers the period 1 July to 30 September 2013.

Details of potential class actions in relation to companies in which Lancashire County Pension Fund owns, or has owned shares is also set out in the report.

An update on recent developments relating to fiduciary duty is also provided to the Committee.

Recommendation

The Committee is asked:

1. to note the report.
2. to welcome the Law Commission's review of fiduciary duty and to agree to review the position with regard to ethical investment and returns when the findings of the Law Commission are published.

Background and Advice

1. Shareholder Voting and Governance

PIRC, acts as the Fund's proxy and casts the Fund's votes on its investments at shareholder meetings. PIRC are instructed to vote in accordance with their guidelines unless the Fund instructs an exception. PIRC analyses investee companies and produces publically available voting recommendations to encourage companies to adhere to high standards of governance and social responsibility. The analysis includes a review of the adequacy of environmental and employment policies and the disclosure of quantifiable environmental reporting. PIRC is also an active supporter of the Stewardship Code, a code of practice published by the Financial Reporting Council with the aim of enhancing the quality of engagement between institutional investors and companies.

There may be occasions when the Fund wishes to cast a vote at a shareholder meeting in a way which does not accord with PIRC's recommendations. For example, an investment manager might request the Fund to vote in a particular way to support or oppose a corporate action. Such requests would be considered by the Fund on a case by case basis and PIRC instructed to cast the Fund's vote accordingly.

PIRC also lobbies actively on behalf of its investing clients as well as providing them with detailed support. It works closely with NAPF (the National Association of Pension Funds) and LAPFF (the forum of Local Authority Pension Funds).

PIRC's quarterly report to 30 September is presented at Appendix 'A'. This report not only provides details of the votes cast on behalf of the Fund but also provides a commentary on events during the period relevant to environmental and social governance issues.

In addition PIRC produces a detailed document which is reviewed by the Fund's officers, which sets out the circumstances and reasoning for every resolution opposed, abstained or withheld. This document is available on request.

The Fund's voting record using PIRC as its proxy for the three months ended 30 September 2013 is summarised below:

TABLE 1: GEOGRAPHIC VOTING OVERVIEW

Geographic Region	Meeting	Resolutions	For	Oppose	Abstain	Withheld	Non-Voting
SOUTH AND CENTRAL AMERICA	0	0	0	0	0	0	0
REST OF THE WORLD	2	66	31	26	9	0	0
ASIA	0	0	0	0	0	0	0
NORTH AMERICA	7	96	59	20	6	11	0
UK	7	136	105	12	19	0	0
EU	6	85	34	36	8	0	6
JAPAN	1	9	5	4	0	0	0

TABLE 2: ANALYSIS OF UK ALLSHARE VOTING RECOMMENDATIONS

Resolution Type	For	Percentage %	Abstain	Percentage %	Oppose	Percentage %	Total
Annual Reports	4	57.14	2	28.57	1	14.29	7
Remuneration Reports	0	0.0	2	28.57	5	71.43	7
Articles of Association	0		0		0		0
Auditors Appointment	4	57.14	3	42.86	0	0.0	7
Directors	55	77.46	12	16.9	4	5.63	71
Dividend	6	100.0	0	0.0	0	0.0	6
Executive Pay Scheme	0	0.0	0	0.0	1	100.0	1

The Fund was party to 392 resolutions during this period, of which 60% resulted in positive votes for shareholder resolutions and 36% were opposed or an abstention given. Voting abstention is regularly used by institutional investors as a way of signalling a negative view on a proposal without active opposition. In addition, within certain foreign jurisdictions, shareholders either vote for a resolution or not at all, opposition to these votes is described as vote withheld. These totalled 11 within the period, just under 3%. The remaining agenda items required no vote.

In relation to the UK, this quarter's report focuses upon the Competition Commission's proposals to reform the external audit arrangements of FT350 companies, a Department of Business, Innovation and Skills report suggesting that stock exchange listing led to increased levels of reporting and corporate governance, and a leading legal firm maintaining that a director's fiduciary duty is not to maximise shareholder value through tax avoidance.

Within European markets, shareholders led by German investor group DSW have won an agreement from steel and industrial goods group ThyssenKrupp to hold an independent governance review. Separately, large financial services businesses may have to set board diversity targets under European Union plans, and Italy has become the first country to push ahead with introducing a tax on high-frequency trading.

The Italian Financial Transactions Tax will be explicitly focused on high-frequency trading and equity derivatives, which are often used by banks and companies to hedge against risk. Once above the threshold, order changes and cancellations of high-frequency traders will now be taxed at 0.02 per cent when they occur in intervals shorter than half a second. The levies will apply regardless of the place of the transaction or the country of residence of the counterparty.

Within the United States, the Securities and Exchange Commission (SEC) is seeking that US companies will need to disclose how the pay of their CEOs compares to that of their workers. Separately, shareholders have filed a proposal to abandon the dual shares class structure at Twenty-First Century Fox, which also faces a resolution from Christian Brothers Investment Services seeking the splitting of chair and chief executive roles.

Elsewhere, the Australian Council of Superannuation Investors (ACSI) has published updated advice to corporate Australia on how it will be assessing public company directors' behaviours and performance. ACSI's Governance Guidelines, updated in July, provide expanded context and commentary on investor expectations of board practices, executive pay structures and conduct during capital raisings.

China's environmental watchdog has halted new projects by the country's two largest refining companies because they missed pollution targets. The Chinese Ministry of Environmental Protection has temporarily banned new constructions as well as renovation and expansion of the existing refineries of China National Petroleum Corp. (CNPC) and China Petrochemical Corp., known as Sinopec Group. Together they account for more than three-quarters of China's total refining capacity. According to the Ministry, CNPC missed a target to reduce chemical-oxygen-demand, which is an indicator of water pollution, while Sinopec missed a target to reduce nitrogen-oxide emissions, a metric for air pollution.

The bans are a rather unusual step by the Chinese authorities, which shows that Beijing is stepping up environmental scrutiny of state-owned companies after mounting public discontent over environmental pollution in China. In January, this year, Beijing and several other locations suffered from severe air pollution and cadmium-tainted rice has been discovered in supplies in the southern province of Guangdong.

2. Shareholder Engagement through LAPFF

Lancashire County Pension Fund is also a member of the Local Authority Pension Fund Forum (LAPFF), which exists to promote the investment interests of local authority pension funds, and to maximise their influence as shareholders whilst promoting social responsibility and corporate governance at the companies in which they invest.

Members of the Committee may be interested to note the attached engagement report from LAPFF (Appendix 'B') which covers the period 1 July to 30 September 2013.

It sets out details of their activities in influencing governance, employment standards, reputational risk, climate change, finance and accounting, and Board composition, and provides a slightly different and wider perspective than the PIRC report.

3. Class Actions

United States

The Fund has appointed Barrack, Rodos and Bacine (BR&B) to provide a US class actions monitoring service with the aim of ensuring that the Lancashire County Pension Fund receives all monies due to the Fund by filing its proof of claim from these cases. This service is at no cost to the Fund.

BRB will identify class actions where the Fund has a potential loss arising from an alleged fraud or a securities law violation. This is achieved by the BR&B 'BEAMS' monitoring system which follows each securities case from the beginning to the end by ensuring its filing of the proof of claim so that the Fund may receive its payment.

Occasionally the Fund may be asked to participate in a class action, and/ or to apply to become the lead or co-lead plaintiff, but under US law any shareholder subject to such a loss will be automatically entered into and benefit from a class action without having to file an individual claim.

Details of current potential US cases as at 30 September 2013 are set out below:

<u>Company Name</u>	<u>Effective Class Period Begin</u>	<u>Effective Class Period End</u>	<u>Case Status</u>	<u>Potential loss incurred (\$'000)</u>
Medtronic, Inc.	08/12/10	03/08/11	ACTIVE	27.71
CenturyLink, Inc.	08/08/12	14/02/13	ACTIVE	521.63
Barrick Gold Corp.	07/05/09	23/05/13	ACTIVE	411.36
Intuitive Surgical, Inc.	19/10/11	18/04/13	ACTIVE	251.54
ITT Educational Services, Inc.	24/04/08	25/02/13	ACTIVE	760.06

United Kingdom

Unlike class actions within the US jurisdiction, where all relevant recipients benefit from a class action when filed, class actions within the UK require investors to file their actions individually in order to potentially benefit from a successful class action. Such actions are therefore much less prevalent.

As reported at the previous meeting, and in keeping with the majority of other affected LGPS, the Fund is keeping a watching brief over developments in relation to Royal Bank of Scotland in relation to alleged actions that, it is argued, caused investors to suffer losses relating to a subsequent Rights Issue on 30 April 2008. The deadline for filing a claim, after which the case would be statute-barred, remains April 2014.

4. Fiduciary duty update

Following discussion of fiduciary duties at the March 2013 meeting of the Committee, there has been activity on a number of fronts relating to LGPS funds, much of which arises from many administering authorities taking on responsibility for Public Health from April 2013.

The previous report on fiduciary duty, presented to this Committee in March 2013, considered the question of whether a conflict arose between the County Council's then imminent take-on of public health responsibilities, the role of the County Council as administering authority for the Fund and the Fund's responsibilities regarding fiduciary duty. It also set out the Lancashire County Pension Fund's position, similar to that of Norfolk Pension Fund below, of maintaining a policy of voting and engagement with companies whose shares are held.

Committee members were informed in March that in order to meet its fiduciary duties, the Pension Fund cannot unilaterally decide to divest from an individual investment type without regard to the overall objectives of the Fund, or without taking appropriate professional advice including risk and return considerations. A decision to exclude particular investments on ethical grounds (and thus affect potential financial return) could be subject to legal challenge. Securing a decent financial

return in order to meet future commitments to beneficiaries is the primary objective of a pension fund.

Since then, work across the LGPS has been ongoing in relation to this issue. In October 2013, a sub-committee of the newly created LGPS Shadow Advisory Board considered the issue and decided upon a number of actions:

- *The approach taken by Norfolk Pension Fund (links below) should be circulated to LGPS Funds as the basis of interim information;*
- *Counsel's opinion should be sought on the legal status of LGPS funds with regard to fiduciary duty and the limit of broader ethical considerations.*

<http://www.norfolk.gov.uk/view/pensions250912item6pdf> (Report); and

<http://www.norfolk.gov.uk/download/pensions250912minspdf> (Minutes)

Essentially, Norfolk Pension Fund Committee recommended that:

- *In light of the new local authority responsibilities for Public Health from April 2013, this Committee informs the Department for Communities and Local Government (as Regulator of the LGPS) of its consideration of this matter and the potential complexities and conflicts of interest for local authorities between their public health responsibilities and investments by LGPS Funds in the tobacco sector.*
- *The Committee monitors the outcome of the proposals within the Kay review of UK Equity Markets and Long-Term Decision Making which suggests further work should be undertaken by the Law Commission into the legal concept of fiduciary duty as applied to investment.*
- *The Norfolk Pension Fund maintains its current policy of voting and engagement and does not pursue exclusion of tobacco holdings but that the situation is reviewed when the legal position relating to the exercise of the Committee's fiduciary duty is clarified.*

Subsequently, the Law Commission has recently issued its consultation paper on fiduciary duty as it applies throughout the investment chain, with a closing date of 22 January 2014. Amongst other things, the paper asks if:

- *The law is right to allow trustees to consider ethical issues only in limited circumstances?*
- *The legal obligations on trustees are conducive to investment strategies in the best interests of the ultimate beneficiaries? And if not, what specifically needs to be changed?*

It is suggested that the Fund welcomes the prospect of greater clarity over fiduciary duty that these developments are intended to provide, and it is proposed that Lancashire County Pension Fund reviews the position when the outcome of the Law Commission's review of fiduciary duty is published.

Consultations

N/A

Implications:

It is a key component of good governance that the Fund is an engaged and responsible investor complying with the Stewardship Code.

Well run responsible companies are more likely to be successful and less likely to suffer from unexpected scandals.

In order to meet its fiduciary duties, the Pension Fund cannot unilaterally decide to divest from an individual investment type without regard to the overall objectives of the Fund, or without taking appropriate professional advice including risk and return considerations. A decision to exclude particular investments on ethical grounds (and thus affect potential financial return) could be subject to legal challenge.

Risk management

The promotion of good responsible corporate governance in the companies the Fund is invested in reduces the risk of unexpected losses arising as a result of poor oversight and lack of independence.

Involvement in a non-US class action may result in losses incurred being recovered for the Fund, but should a case be lost then the Fund may incur related costs which may not be known with certainty at the time of filing. Applying for lead plaintiff status in the US may incur significant officer time and resources in bring a potential case to fruition.

Local Government (Access to Information) Act 1985 List of Background Papers

N/a