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REVIEW OF EQUITY MANAGER VOTING AND ENGAGEMENT

HERTFORDSHIRE COUNTY COUNCIL PENSION FUND

Background

This paper has been prepared for the Pension Committee ("PC") of the Hertfordshire County Council Pension Fund (the "Fund") to provide an assessment of the voting and engagement policies and activity of the Fund's equity managers via their compliance with the UK Stewardship Code. Following its review of the voting process across the Fund, the PC recently agreed to return the responsibility for voting activities to the investment managers in order that the stewardship decision is aligned with the decision-making to buy or sell individual stocks.

This paper is designed to provide a high level assessment of each of the manager's voting and engagement activities relative to the expectations of the UK Stewardship Code in order to assist the PC with monitoring the voting and engagement activities of the managers. We recommend that more detailed voting analysis and monitoring takes place in 2018 post the busy proxy voting season in the second quarter of 2018.

The UK Stewardship Code (the "Code") for institutional investors was introduced in 2010, and updated in 2012, by the Financial Reporting Council ("FRC"). The Code is complementary to the UK Corporate Governance Code (formerly the Combined Code) for listed companies – the aim of which is to increase the accountability of company boards and encourage them to seek on-going dialogue with investors; the Code is intended to incentivise investors to do the same.

It is a mandatory requirement of the Financial Conduct Authority ("FCA") that UK authorised asset managers disclose their compliance with the Code or explain otherwise through a public 'Statement of Commitment'. However, acknowledging that the issues underpinning good stewardship are global in nature this review leverages the Code as a framework for global good practice.

The FRC decided not to amend the Code in 2014; instead it chose to focus on implementation of the Code by signatories and published its findings in January 2015.
In particular, the FRC stated the following:

- It is concerned that "not all signatories are following through on their commitment to the Code."
- "Most signatories to the Code would benefit from considering ways in which they can be more accountable to their clients and beneficiaries and fully explain their approach to stewardship."
- Further, for some signatories "signing up to the Code is not necessarily a basis for good quality engagement, but is seen as a box-ticking exercise or a necessary hurdle".
- As a result, from 2015 the FRC "will undertake greater scrutiny of adherence to the Code".

The FRC also emphasises in its 2015 report that asset owners are “key to driving stewardship through the investment chain”.

Over 2016, the FRC undertook a review to ‘tier’ the disclosures of all signatories to the Code by category (investment manager, asset owner, service provider) in order to distinguish best practice. The results of the assessment by the FRC were published at the end of 2016 and in addition some signatories were delisted as signatories to the Code. Mercer has engaged with the FRC on this process and has shared examples of our assessment approach with the FRC. Upon releasing its findings, the FRC noted:

“In 2016 the FRC assessed signatories to the Stewardship Code based on the quality of their Code statements. This work was undertaken to improve the quality of reporting against the Code, encourage greater transparency in the market and maintain the credibility of the Code. Tiering distinguishes between signatories who report well and display their commitment to stewardship, and those where reporting improvements are necessary. The tiering exercise has improved the quality of reporting against the Code, promoted best practice and resulted in greater transparency in the UK market.”

Signatories have been divided into three groups: investment managers, asset owners and service providers. The investment manager category was initially split into three tiers (Tier 1 identifying industry leaders), with only two tiers for asset owners and service providers.

The FRC recently took the decision to remove the Tier 3 category on the basis that the majority of signatories initially assessed as Tier 3 had significantly improved their statements, but some remained in Tier 3, meaning their reporting required significant improvement. These asset managers were given a period of time to improve their reporting or be removed from the list of Code signatories. With its recent removal of the Tier 3 category, the FRC has de-listed those asset managers that remained in Tier 3.

The number of signatories by Tier is shown below:

	Investment Managers	**Asset Owners**	**Service Providers**
Tier 1	96 signatories	61 signatories	11 signatories
Tier 2	56 signatories	24 signatories	-

As at August 2017

The Code’s seven Principles are set out overleaf.

Institutional investors should:

- Principle 1: Publicly disclose their policy on how they will discharge their stewardship responsibilities
- Principle 2: Have a robust policy on managing conflicts of interest in relation to stewardship which should be publicly disclosed
- Principle 3: Monitor their investee companies
- Principle 4: Establish clear guidelines on when and how they will escalate their activities
- Principle 5: Be willing to act collectively with other investors where appropriate
- Principle 6: Have a clear policy on voting and disclosure of voting activity
- Principle 7: Report periodically on their stewardship and voting activities.

The Code is applied on a “comply or explain” basis and the FRC recognises that not all parts of the Code are relevant to all signatories. Signatories are required to issue a statement of commitment, outlining their level of compliance with each principle.

Assessment of compliance with the UK Stewardship Code

We set out below Mercer’s stewardship assessment summary for the Fund’s equity managers; namely, Allianz Global Investors (“Allianz”), Baillie Gifford, Jupiter Asset Management (“Jupiter”) and Legal & General Investment Management (“LGIM”). Mercer’s analysis is compiled by evaluating each manager’s public disclosures as well as additional documentation where cited.

Summary of compliance with the Code

The table overleaf summarises the current state of compliance for the Fund’s equity managers against each of the Code’s principles. The compliance metrics are summarised below, with a new Green+ category introduced by Mercer in 2016, representing positive industry developments and best practice. Further detail on each Principle and the criteria indications for each are provided in the Appendix.

Compliance levels for **each Principle** are indicated as follows:

- **Green+:** Best practice compliance with comprehensive public disclosure.
- **Green:** Good practice compliance with quality public disclosure.
- **Amber:** Partial compliance or limited explanation, with improvements recommended.
- **Red:** Non-compliance and no explanation.

Compliance levels **overall** are indicated as follows:

- **Green+:** Best practice i.e. comprehensive compliance with guidelines for all seven principles.
- **Green:** Good practice i.e. compliance with majority of principles at good or best practice levels, with no non-compliance.
- **Amber:** Partial compliance i.e. majority of principles are partially compliant or non-compliant.
- **Red:** Non-compliance and no explanation i.e. no principles are met.

	Overall Compliance	Principle						
		1	2	3	4	5	6	7
Allianz								
Baillie Gifford								
Jupiter								
LGIM								

Mercer assessments

Allianz	Overall Assessment	Principle						
		1	2	3	4	5	6	7

In our view, Allianz is compliant with the Code, with some improvement areas.

Allianz's current compliance by Principle is summarised below:

1. Disclosure on how stewardship responsibilities are discharged is captured in a UK Stewardship Code Statement of Commitment and various policy documents, which are publicly disclosed.
2. A policy on the management of potential conflicts of interest, specific to stewardship, is integrated into the manager's "Global Corporate Governance Guidelines", which is publicly disclosed.
3. Allianz regularly meets with investee companies and challenges management about fundamental and ESG issues. Written opinions are sent to company management from Allianz senior leadership and on behalf of the entire organisation.
4. Allianz details a number of methods by which it may choose to escalate its stewardship activities; however, the disclosure does not constitute clear guidelines on how and when these methods will be used.
5. Allianz is willing to act collaboratively and cites fellow signatories to the PRI as examples of partners with which it is actively involved in doing so, including examples.
6. A comprehensive policy on voting and disclosure is detailed in the manager's "Global Corporate Governance Guidelines", which is publicly disclosed, as are voting records.
7. Allianz provides its clients with quarterly voting reports and an engagement activity report but does not publicly disclose a comprehensive report of its stewardship activities.

We note that Allianz has been classified as Tier 1 compliant by the FRC.

Baillie Gifford	Overall Assessment	Principle 1	2	3	4	5	6	7

In our view, Baillie Gifford is best practice compliant with all seven principles of the Code. Baillie Gifford's disclosure against the Code is comprehensive. Companion policies (e.g. "Policy on Company Engagement", "Global Corporate Governance Principles and Guidelines", "ESG Policy") indicate an approach to stewardship that is well integrated with the manager's wider investment process.

Baillie Gifford's current compliance by Principle is summarised below:

1. Baillie Gifford has a comprehensive policy on how it will discharge its stewardship responsibilities, and this is publicly disclosed.
2. Potential conflicts of interest will be managed at a senior level where necessary to ensure that actions are taken in the best interest of clients. Baillie Gifford publicly discloses its policy on managing potential conflicts of interest.
3. The manager actively monitors investee companies and communicates its views to management. Records are kept of all dialogue with investee company boards.
4. The manager's Policy on Company Engagement is publicly disclosed and provides comprehensive disclosure on how stewardship activities will be escalated with company management.
5. Baillie Gifford is willing to act collectively with other investors, and publicly discloses examples of collaborative bodies of which it is a member.
6. The manager maintains its own voting policy which is publicly disclosed.
7. The manager maintains records of its voting and stewardship activities, and has obtained independent opinion on the quality of its voting and engagement processes. Detailed reports are sent to clients as a matter of course.

We note that Baillie Gifford has been classified as Tier 1 compliant by the FRC.

Jupiter	Overall Assessment	Principle 1	2	3	4	5	6	7

In our view, Jupiter is compliant with all seven principles of the Code, demonstrating best practice compliance in several areas. Jupiter's disclosure against the Code is comprehensive.

Jupiter's current compliance by Principle is summarised below:

1. Jupiter has a detailed statement setting out how it discharges its stewardship responsibilities and this is publicly disclosed.
2. Jupiter provides an outline of how it manages potential conflicts of interest related to stewardship. To meet best practice, we would expect a more detailed response providing clarity on the process and actions taken with respect to the management of stewardship-related potential conflicts of interest.
3. Jupiter actively monitors investee companies and communicates its views to company management.
4. Jupiter outlines its approach to escalation of stewardship activities in its Statement of Commitment to the Code. However, to meet best practice, we would expect additional detail of the escalation process and the decision-making responsibility around this.
5. Jupiter is willing to act collectively with other investors, and publicly discloses examples of collaborative bodies of which it is a member.
6. Jupiter has a comprehensive Corporate Governance and Voting Policy, which is publicly disclosed. Jupiter releases details of its voting records publicly on a monthly basis.
7. The manager details its stewardship and engagement activities in a comprehensive annual Voting & Engagement report. This report is made available publicly. Jupiter has obtained independent opinion on the quality of its processes.

We note that Jupiter has been classified as Tier 1 compliant by the FRC.

LGIM	Overall Assessment	Principle						
		1	2	3	4	5	6	7

In our view, LGIM demonstrates best practice compliance with all seven principles of the Code. LGIM has prepared comprehensive disclosure against the Code and provides details on its voting and engagement process, which are coordinated centrally through its well-regarded Corporate Governance and Responsible Investment team.

LGIM's current compliance by principle is summarised below:

1. The manager publicly discloses its Corporate Governance General Policy as well as regional specific policies. Each policy comprehensively sets out how LGIM will discharge its stewardship responsibilities.
2. The manager publicly discloses a specific policy on managing potential conflicts of interest related to corporate governance and stewardship, noting that it has a Corporate Governance Board consisting of five directors, including two independent non-executive directors from outside the organisation. LGIM's Corporate Governance team is frequently in possession of 'insider' information in undertaking its engagement activities. The policy sets out LGIM's process for managing potential conflicts in this respect.
3. LGIM monitors investee companies, consistent with its investment process and highlights the actions it may take, including private meetings with a company and collaboration with other investors on common issues.
4. LGIM's dedicated Corporate Governance and Responsible Investment team works to identify cases in which escalation is required. Escalation activities include voting against resolutions at company annual general meetings and, as a last resort, LGIM will make a public statement detailing its discontent.
5. LGIM is an active participant of many collaborative investor initiatives. LGIM also engages on public policy. LGIM demonstrates a high level of collaboration and shares examples of its collaborative engagement activities.
6. LGIM details its approach to proxy voting in its Corporate Governance & Responsible Investment Policy, which is publicly disclosed. Voting records are released publicly.
7. Comprehensive voting and engagement reports, detailing examples of stewardship, are disclosed publicly on a regular basis. LGIM has obtained independent opinion on the quality of its processes.

We note that LGIM has been classified as Tier 1 compliant by the FRC.

Summary and next steps

In our view, all managers demonstrate overall compliance with the Code, with Baillie Gifford and LGIM demonstrating best practice compliance with all principles.

We would recommend that the PC:

- Commends both Baillie Gifford and LGIM on their demonstrable commitment to the Code.
- Encourages both Allianz and Jupiter to set out clearer guidelines for when and how they seek to escalate via stewardship activities.
- Encourages both Allianz and Jupiter to provide additional clarity on their management of potential conflicts of interest specifically related to stewardship and engagement activities.
- Encourages Allianz to develop more comprehensive public reporting of its stewardship activities.
- Continues to monitor all managers' stewardship and engagement activities on a regular basis.

The PC could also consider building on its disclosures related to stewardship within the Fund's Investment Strategy Statement by publishing a statement of commitment for the Fund and communicate the Fund's support to the FRC.

We also recommend that the PC reviews the compliance of the managers with the Code again in twelve months' time and undertakes a more detailed review of the managers voting and engagement activity following the 2018 proxy voting season.

Important Notices

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Appendix A: Background to the Code

In November 2009, the Institutional Shareholders Committee ("ISC") published a "Code on the Responsibilities of Institutional Investors" (the "ISC Principles"), following a consultation exercise with institutional investors. The primary aim of the ISC Principles was to enhance the quality of the dialogue between institutional investors and companies, in order to help improve long term returns to shareholders, reduce the risk of catastrophic outcomes due to bad strategic decisions and help with efficient exercise of governance responsibilities. The National Association of Pension Funds (NAPF) (now the Pensions & Lifetime Savings Association (PLSA), which is a member of the ISC, stated its full support for the ISC Principles.

Following a review of corporate governance in the UK financial sector, Sir David Walker recommended a stewardship code for institutional investors be developed. The Financial Reporting Council ("FRC") agreed to take on responsibility of overseeing the development of the new code at the request of the Government. It was agreed that the ISC Principles would form the basis for the new code and in July 2010 the FRC formally published the slightly revised ISC Principles under a new title, the UK Stewardship Code (the "Code").

It was agreed that the Code would be formally reviewed every two years. The last review was conducted by the FRC in 2012. After a consultation exercise the FRC published an updated edition of the Code in September 2012.

Key highlights of the 2012 changes are detailed below:

- The FRC clarified the respective responsibilities of investment managers and asset owners with regards to stewardship and for stewardship activities that they have chosen to outsource. The key point with regards to delegation is that while it is acceptable to delegate some activities relating to stewardship, the responsibility cannot be delegated away. The Code is now much more explicit regarding the role of asset owners stating that:

    - "...asset owners should seek to hold their managers to account for their stewardship activities. In doing so, they better fulfil their duty to their beneficiaries to exercise stewardship over their assets."
    - Investors are to explain more clearly how they manage conflicts of interest, the circumstances in which they will take part in collective engagement, and the use they make of proxy voting agencies.
    - Investment managers are encouraged to have the processes that support their stewardship activities independently verified, to provide greater assurance to their clients.
    - The FRC encourages an annual review cycle with respect to stewardship activities.

The FRC decided not to amend the Code in 2014; instead it chose to focus on implementation of the Code by signatories and published its findings in January 2015.

In particular, the FRC states the following:

- It is concerned that “not all signatories are following through on their commitment to the Code.”
- “Most signatories to the Code would benefit from considering ways in which they can be more accountable to their clients and beneficiaries and fully explain their approach to stewardship.”
- Further, for some signatories “signing up to the Code is not necessarily a basis for good quality engagement, but is seen as a box-ticking exercise or a necessary hurdle”.
- As a result, from 2015 the FRC “will undertake greater scrutiny of adherence to the Code”.

The FRC also emphasises in its 2015 report that asset owners are “key to driving stewardship through the investment chain”.

The Code’s seven Principles are:

- Principle 1: Institutional investors should publicly disclose their policy on how they will discharge their stewardship responsibilities;
- Principle 2: Institutional investors should have a robust policy on managing conflicts of interest in relation to stewardship which should be publicly disclosed;
- Principle 3: Institutional investors should monitor their investee companies;
- Principle 4: Institutional investors should establish clear guidelines on when and how they will escalate their activities;
- Principle 5: Institutional investors should be willing to act collectively with other investors where appropriate;
- Principle 6: Institutional investors should have a clear policy on voting and disclosure of voting activity;
- Principle 7: Institutional investors should report periodically on their stewardship and voting activities.

The Code is applied on a “comply or explain” basis and the FRC recognises that not all parts of the Code are relevant to all signatories. Signatories are required to issue a statement of commitment, outlining their level of compliance with each principle. Where a signatory chooses not to comply with the principles of the Code, or not follow the guidance, they should deliver meaningful explanations as to how their differing approach promotes good stewardship and contributes to meeting the institution’s or client’s investment objectives.

Appendix B: The FRC Guidelines by Principle

Principle 1	Institutional investors should publicly disclose their policy on how they will discharge their stewardship responsibilities

FRC Guidelines

- Effective stewardship benefits companies, investors and the economy as a whole.
- *Stewardship activities include monitoring and engaging with companies on issues including strategy, performance, risk and corporate governance.*
- The stewardship policy should address:
  - How stewardship is applied with the aim of enhancing and protecting the value for the ultimate beneficiary or client.
  - How investee companies will be monitored on issues including strategy, risk and corporate governance.
  - How stewardship is integrated within the wider investment process.
  - How outsourced stewardship activities (where relevant) are compatible with the proper exercise of stewardship responsibilities.

No policy; Policy but limited and/or not public; Good public policy; Comprehensive public policy

Principle 2	Institutional investors should have a robust policy on managing conflicts of interest in relation to stewardship which should be publicly disclosed

FRC Guidelines

- An institutional investor's duty is to act in the best interests of its clients and/or beneficiaries.
- The policy on conflicts of interest should:
  - Be publicly disclosed.
  - Address conflicts related to stewardship (e.g. when voting on matters affecting a parent company).
  - Explain how, when the interests of clients/beneficiaries diverge, these issues are managed.

No policy; Policy but limited and/or not public; Good public policy; Comprehensive public policy

Principle 3	Institutional investors should monitor their investee companies

FRC Guidelines

- Regular monitoring of investee companies is an essential component of stewardship. The process should be checked periodically for its effectiveness.
- As part of this monitoring, institutional investors should:
  - Keep abreast of the company's performance and developments that drive the company's value and risks.
  - Consider the quality of the company's reporting.
  - Satisfy themselves that the investee company has effective leadership, and that its board and committee structures adhere to the spirit of the UK Corporate Governance Code.

- – Consider carefully explanations given by investee companies for departure from the UK Corporate Governance Code.
- – Endeavour to identify at an early stage issues that may result in a significant loss in investment value, and engage accordingly.

No company monitoring process disclosure; Limited disclosure; Good disclosure; Comprehensive disclosure

Principle 4	Institutional investors should establish clear guidelines on when and how they will escalate their stewardship activities.

FRC Guidelines

- Engagement (intervention) should be considered for both active and passive strategies. Underweight positions should not prevent engagement.
- Areas of concern leading to engagement can include: strategy, performance, governance, remuneration or environmental and social risks.
- Initial discussions should take place confidentially. If boards do not respond constructively then investors should consider escalation options, for example:
  - – Holding additional meetings with management specifically to discuss concerns;
  - – Expressing concerns through the company's advisers;
  - – Meeting with the chairman or other board members;
  - – Intervening jointly with other institutions on particular issues;
  - – Making a public statement in advance of General Meetings;
  - – Submitting resolutions and speaking at General Meetings; and
  - – Requisitioning a General Meeting, in some cases proposing to change board membership.

No escalation guidelines disclosure; Disclosure – but not clear guidelines; Good disclosure; Comprehensive disclosure

Principle 5	Institutional investors should be willing to act collectively with other investors where appropriate

FRC Guidelines

- At times, investor collaboration may be the most effective manner in which to engage, in particular at times of significant corporate or wider economic stress.
- Stewardship policies or statements should:
  - – Disclose the investors' policy on collective engagement, indicating their readiness to work with other investors through formal and informal groups.
  - – Indicate the circumstances in which the investor would consider participating in collective engagement.

No collective action disclosure; Disclosure, but no indicative circumstances; Good disclosure; Comprehensive disclosure

Principle 6	Institutional investors should have a clear policy on voting and disclosure of voting activity

FRC Guidelines

- Investors should seek to vote all shares held and not automatically support the board.
- If investors are unable to reach a satisfactory outcome through active dialogue they should register an abstention or vote against the resolution.
- Investors should publicly disclose voting records.
- Investors should disclose the use made, if any, of proxy voting, or other voting, services. They should describe the scope of such services, identify the providers and disclose the extent to which they follow, rely upon or use recommendations made by such services.
- Investors should disclose their approach to stock lending and recalling lent stock (voting purposes).

No disclosure; Policy but limited and / or not public; Good public policy and voting activity disclosure; Comprehensive public policy and voting activity disclosure

Principle 7	Institutional investors should report periodically on their stewardship and voting activities

FRC Guidelines

- Institutional investors should maintain a clear record of their stewardship activities and regularly inform clients as to how they have discharged their responsibilities. Reporting to clients will likely comprise qualitative as well as quantitative information (e.g. voting statistics and explanations for specific voting decisions).
- Investors should not be expected to make disclosures that might be counterproductive – confidentiality in specific situations may be crucial to achieving a positive outcome.
  Investment managers should obtain an independent opinion on engagement and voting processes. The AAF 01/06 framework is an appropriate standard in the UK. The existence of such assurance reporting should be publicly disclosed and provided to clients if requested.

No disclosure; Limited reporting; Good stewardship reporting; Comprehensive stewardship reporting