

Pensions Committee

2.00 p.m., Tuesday, 6 December 2016

Stewardship

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|-------------------|-----|
| Item number | 5.5 |
| Report number | |
| Executive/routine | |
| Wards | All |

Executive summary

This report provides the annual update on the activity of the Lothian Pension Fund, Lothian Buses Pension Fund and Scottish Homes Pension Fund (the Funds) in relation to the stewardship of the assets of the Funds, including the approach to environmental, social and governance (ESG) issues. The Funds pursue a policy of constructive engagement on such issues, which is consistent with fiduciary duties. The Fund's voting and engagement provider is scheduled to present at the Committee meeting.

This report also provides an annual update on the Funds' class action activity. A class action is a type of lawsuit in which a group (a class) sues another party. Typically, these actions happen in the US. The type of class action relevant to the Funds is one in which a group of shareholders collectively sues a company in order to recover a loss in share value, or to exert influence on the company. Since 2006 the fund has received US\$3.4 million in class action compensation.

Links

Coalition pledges

Council outcomes [CO26](#)

Single Outcome Agreement

Stewardship

Recommendations

Committee is requested to:

- 1.1 That Committee invites the Pension Board to raise any relevant matters or concerns which the Committee should consider.
- 1.2 That Committee notes the contents of this report.
- 1.3 That Committee considers nominating a member to stand for election to the Local Authority Pension Fund Forum (LAPFF) Executive at the January 2017 AGM (the appointment being subject to approval by Council).

Background

- 2.1 The Funds pursue a policy of constructive engagement on issues, which is consistent with fiduciary duties. As reported in September 2016, the Scheme Advisory Board of the Scottish Local Government Pension Scheme has shared the legal opinion on the exercising of fiduciary duties by Pensions Committees in Scotland that it had received. The opinion essentially reaffirms the position taken by Senior Counsel in England & Wales, confirming that the advice is also applicable in Scotland. This in turn reinforces the approach taken by the Funds to date.
- 2.2 As previously reported to Committee, the ability of investors to seek redress via class actions in the US has been narrowed since 2010.

Main report

Voting and Engagement

- 3.1 The voting and engagement arrangements for the Funds' equity holdings are shown in the tables below.

| Mandate | Voting and Engagement Arrangement |
|---|--|
| Baillie Gifford (Global - Lothian Buses Pension Fund) | Baillie Gifford |
| State Street Pooled Funds (for Scottish Homes Pension Fund) | State Street |
| All other listed equities | Hermes Equity Ownership Services (EOS) |

- 3.2 Details of voting and engagement during the financial year 2015/16 can be found in the Fund's annual report. From the beginning of the financial year 2016/17, Hermes has voted on behalf of Lothian Pension Fund at 367 meetings covering 5,292 resolutions. Of these, 56% of votes were cast in support of management, 43% against with 1% abstention. Of the 1,300 resolutions voted against or abstained, 23% was on board structure, 22% on remuneration, and 35% was against resolutions brought by shareholders.
- 3.3 On behalf of the Funds and other like-minded investors, Hermes EOS undertakes engagement with companies on behalf of shareholders, covering a broad array of environmental, social and governance matters. Hermes Public Engagement Reports provide information on engagements and a link to the reports is provided later in this report.
- 3.4 Executive remuneration remains a key engagement theme. Shareholder revolts with regards executive pay have been seen in 2016, including WPP and Deutsche Bank. Hermes EOS is leading calls to simplify the pay packages of top executives, clearly delineate performance pay and explain how it is structured, and encourage significant parts of variable packages to be paid in restricted shares, that would have to be held far longer than an executive's tender.
- 3.5 Corporate governance practices in Japan have long lagged behind the example set by Europe. Recently, the Japanese financial regulator introduced the Principles for Responsible Institutional Investors, which was followed by the country's first Corporate Governance Code. The Code requires boards to have at least two independent directors. Hermes EOS has been engaging on this topic with Japanese companies for many years, achieving some notable success. While the rules are not yet perfect, they are a step in the right direction and Hermes EOS intend to engage on greater board independence and diversity.

Local Authority Pension Fund Forum (LAPFF)

- 3.6 Lothian Pension Fund was a founding member of the LAPFF when it was established in 1990. It promotes the long-term investment interests of local authority pension funds and aims to maximise their influence as shareholders to promote corporate social responsibility and high standards of corporate governance amongst the companies in which they invest, commensurate with statutory regulations. Its membership has increased over recent years (currently 71 of the 110 UK local government pension schemes).
- 3.7 LAPFF, alongside Carbon Tracker, recently released the paper *Engaging for a Low Carbon Transition* (available on the LAPFF website). The report argues that the rise in global temperatures through global warming should be limited to 2 degrees and efforts be made for a 1.5 degree limit. This involves a different kind of engagement, pushing for better targeted investment in oil and gas. This is on the basis that high levels of investment will lead to a glut of reserves on company balance sheets, and that these reserves could never be fully utilised due to carbon emission limits, thereby destroying shareholder value through overinvestment. Further to this, the Transition Pathway Initiative has been

developed by a group of asset owners including Environment Agency Pension Fund and the Church of England to support effective engagement on the transition to a low carbon economy. It aims to provide a simple but rigorous, freely available, transparent framework to track engagement and analyse company responses to climate and carbon risk. LAPFF has agreed to support the initiative and participate in its ongoing development.

- 3.8 Councillor Cameron Rose is currently Vice Chair of the Executive Committee of the LAPFF. The role entails participating in quarterly meetings of the LAPFF executive and also the quarterly Business meetings. Councillor Rose also participates in LAPFF’s engagement meetings with companies. Councillor Rose will provide a verbal update to Committee on his role on the Executive.
- 3.9 Committee is asked to consider nominating a member to stand for election to the Executive at the AGM in January 2017. If successful, Council’s approval of the appointment will be sought.

Principles for Responsible Investment (PRI)

- 3.10 Lothian Pension Fund signed the PRI in 2008. The PRI is a global network for investors to publicly demonstrate their commitment to responsible investment, to collaborate and learn with their peers about the financial and investment implications of ESG issues, and to incorporate these factors into their investment decision making and ownership practices.
- 3.11 Signatories complete a self assessment each year to measure progress against the PRI principles and also to allow comparison with peers.
- 3.12 Previous assessments of the Fund’s activities have generally been very good. They have highlighted scope for improvement in ESG integration in investment decision making. As a result, the Fund reviewed options in this area for the internally managed equity portfolios leading to the procurement of an ESG research service which is used by portfolio managers to aid decision making.
- 3.13 The Fund’s 2016 report and scores are available on its website and a link is provided at the end of this report. The results are summarised below.

| | Assets as % of Fund | Module name | LPF Score | Median Score |
|--|----------------------------|----------------------------------|------------------|---------------------|
| Indirect – Manager selection, appointment & Monitoring | n/a | Strategy & Governance | A | B |
| | 10-50% | Listed Equity | A | B |
| Direct and Active ownership | 10-50% | Listed Equity – Incorporation | C | A |
| | >50% | Listed Equity – Active Ownership | A | B |

- 3.14 With the exception of Direct Listed Equity, all areas assessed were scored “A”, with a top score of “A*” available. These are above the median score of “B” for the peer group. The full assessment shows sub-sections where it is possible to improve our performance further and these are being considered.
- 3.15 For Direct Listed Equity, while the systematic use of quantitative ESG data has been integrated into the decision making process since March 2015, they have not been sufficiently well reported to the pension fund members and the employers, leading to no improvement in the “C” score. We are looking at ways to enhance reporting to stakeholders.

Class Actions

- 3.16 In shareholder class actions one or more investors agree to act as lead plaintiff(s). A law firm acts on behalf of the class, with the lead plaintiffs being treated as the representatives of the class. In the US cases are typically taken on a “no win no fee” basis.
- 3.17 If a class action case is won, the compensation fund, net of legal fees approved by the court, is distributed to eligible shareholders who make a claim within the relevant time limit. The Funds claim for compensation on all relevant class action settlements. Compensation received by the Funds from class actions is shown in the table below:

| Financial Year | US\$ (000's) |
|-----------------------|---------------------|
| Prior to 31/03/12 | 2,140 |
| 2012/13 | 483 |
| 2013/14 | 285 |
| 2014/15 | 284 |
| 2015/16 | 124 |
| 2016/17* | 106 |
| Total* | 3,422 |

* to 4 November 2016

Lead Plaintiff and Opt-in Cases

- 3.18 In addition the Funds may act as a lead plaintiff on class actions. However a court ruling in the case of Morrison vs National Australia Bank (NAB) in 2010 narrowed the ability of investors to seek redress under the laws of the US, particularly where shares are purchased on non-US stock exchanges.
- 3.19 The Funds are not currently acting as lead plaintiff, but have done in several cases in the past with little success and minimal compensation received. In some instances the case was difficult to prove and in others the settlement was a small proportion of overall shareholders’ loss.
- 3.20 As a further result of the reduced ability to claim compensation in the US, investors are increasingly looking to claim through other jurisdictions where the legal process may require investors to “opt-in” to the case prior to the trial if they wish to participate.
- 3.21 Officers continue to monitor the potential for such cases but the Funds have not entered into any of these cases. Considerations have included the estimated

financial loss, potential for recovery, the resource needed to monitor the case and the risk of further detriment to the Funds.

Measures of success

- 4.1 Success of engagement with companies is very difficult to measure. The Funds' approach is essentially qualitative and is wide ranging. While the impact is very difficult to quantify, research has shown that companies that undergo active engagement tend to outperform. For example, the "CalPERS Effect" shows that companies engaged with by the CalPERS pension fund outperformed by 14.4% in the five years after engagement started.
- 4.2 The Funds are signatories to PRI and complete the annual self assessment process which compares ESG activity with peers.

Financial impact

- 5.1 There is no financial impact as a result of this report. The costs of the Funds' stewardship activities are included in the pension funds' budget. US class actions are conducted on a "no win no fee" basis. The Funds' are not involved in any non-US actions.

Risk, policy, compliance and governance impact

- 6.1 The stewardship activity of the Funds complies with the Statement of Investment Principles. The Funds' policy is to take environmental, social and governance issues seriously and where appropriate to act upon them in a manner which is consistent with the paramount fiduciary duty to provide the highest standards of stewardship on behalf of the members, employers and tax payers. The Funds' policy of being responsible, informed and involved investors is expected to reduce risk.

Equalities impact

- 7.1 As much of the engagement activity is on equalities issues it is expected to have a positive impact and also to contribute to the sustainability of the Funds' investments.

Sustainability impact

- 8.1 As much of the engagement activity is on sustainability issues, it is expected to contribute to the sustainability of the Funds' investments.

Consultation and engagement

9.1 The Pension Board, comprising employer and member representatives, is integral to the governance of the Funds.

Background reading/external references

Hermes public engagement reports are available to download at <https://www.hermes-investment.com/uki/stewardship/eos-literature/>

LAPFF Carbon report [http://www.lapfforum.org/Publications/latest-research/files/LAPFF CTI Engaging for a Low Carbon Transition.pdf](http://www.lapfforum.org/Publications/latest-research/files/LAPFF_CTI_Engaging_for_a_Low_Carbon_Transition.pdf)

2016 UNPRI assessment report is available at <http://www.lpf.org.uk/lpf1/info/76/unpri>

The CalPERS Effect <https://www.calpers.ca.gov/page/newsroom/calpers-news/2014/company-performance>

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Links

Lothian Pension Fund: http://www.lpf.org.uk/info/68/responsible_investment

United Nations Principles for Responsible Investment <http://www.unpri.org/>

Local Authority Pension Fund Forum <http://www.lapfforum.org/>

Coalition pledges

Council outcomes CO26 - The Council engages with stakeholders and works in partnerships to improve services and deliver agreed

Single Outcome Agreement

Appendices None