



Financial Reporting Council –

Consultation on a Stewardship Code for Institutional Investors

The ABI's Response

Introduction

The ABI is the voice of the insurance and investment industry. Its members constitute over 90 per cent of the insurance market in the UK and 20 per cent across the EU. They control assets equivalent to a quarter of the UK's capital. They are the risk managers of the UK's economy and society. Through the ABI their voice is heard in Government and in public debate on insurance, savings, and investment matters. As a representative of major institutional investors we welcome the opportunity to respond to this consultation on the proposed Code.

Executive Summary

The ABI strongly believes that if the Stewardship Code is to be successful it must be principles-based and the core aims should remain those envisaged under the ISC Code. The Code should contribute to constructive dialogue between companies and investors with the aim of long-term value creation for the benefit of the underlying beneficiary. It should not seek to prescribe investment management style or business model. It also should not become bureaucratic or compliance-driven. If this were to occur, then institutional investors will simply choose not to apply the Code and adopt alternative investment strategies and engagement methods. The Code must be formulated in a way that allows it to apply in a proportionate and effective manner by UK investors and allows overseas investors to support it, without becoming subject to unnecessary regulatory burdens. Given these facts, we strongly believe that the Code must remain investor-led and that the ISC should continue to have responsibility for its content and further development. The FRC's "imprimatur," to use Sir David Walker's expression, is to be welcomed as it will add to the Code's credibility, with FRC's subsequent role being one of oversight that allows the market to be the primary monitoring and enforcement mechanism.

The Code focuses on processes that relate to UK practices and architecture, such as the Combined Code. To aid overseas investors, it would be helpful if the introduction to the Code made clearer reference to these, thereby providing context. Given the interest from overseas, there may be a proliferation of similar Codes. Whilst a greater commitment to responsible ownership is to be welcomed, it may create issues when investors are seeking to invest cross-border. This needs further careful consideration. We must also be aware that for overseas investors any

requirement imposing independent verification may prevent them from being able to sign-up.

Those investors who chose to sign up to the Code should be listed on the ISC website, with a hyper-link for each signatory linked to their individual disclosures. We also believe that in order to rebuild the critical mass and promote collaboration, the contact details of the individual responsible for these matters should be listed on the ISC website.

Background

The ABI is a member of, and currently secretary to, the Institutional Shareholders' Committee which drafted the Code on the Responsibilities of Institutional Investors ("ISC Code") on which the proposed Stewardship Code is based. The ABI's members were heavily involved in the development of the ISC Code and were strong supporters of it when promulgated in November 2009.

When considering the proposed Stewardship Code it is necessary to understand the genesis and intention of the ISC Code. During in 2009, the ISC began to consider the role of shareholders in the aftermath of the financial crisis. It became increasingly apparent that over the last ten to fifteen years the share register of UK listed companies had changed considerably. Traditional long-term investors such as insurers and pension funds held a significantly reduced share of the overall market and this had created issues when such institutions entered into dialogue with companies. Their place had been taken to a degree by investors with non-traditional investment models and by overseas investors, such as sovereign wealth funds. The decline of an engaged core of investors threatened the ability of the comply-or-explain regime to continue to be the basis of UK corporate governance.

Given these changes, the ISC undertook to consider what steps could be taken to rebuild a critical mass of engaged investors. The existing ISC principles on the responsibilities of institutional investors provided the basis for the ISC Code which investors could voluntarily report against on a comply-or-explain basis.

The aim of the Code was therefore to rebuild the critical mass of investors, help sustain the comply-or-explain regime in the UK and provide the asset owners with a high-degree of reporting and transparency so as to allow them to make informed decisions when selecting fund managers and investment styles. The ABI strongly believes that the Stewardship Code must remain in line with these core aims.

Comments on Individual Sections

The following are comments are made on the individual issues raised in the consultation.

Section 1 – Policy Objectives

The Code as currently formulated sets the appropriate standards for institutional investors. The Code must be implemented on a comply-or-explain basis both as to

whether investors apply the Code, and if they do so how this is achieved. The Code should not seek to prescribe business models or investment strategies.

If the Code is to be effective it must remain driven by institutional investors and the providers of mandates (the assets owners/clients). This combination should result in a market that drives best practice developments in the interests of the underlying beneficiaries. This combination of investors and asset owners should help promote the appropriate sense of ownership. If these are not the primary drivers then there is a significant danger that both UK based and overseas shareholders will opt not to apply the Code and instead adopt different investment and engagement strategies.

Proper integration of engagement into the investment process is critically important. However, the Code should not seek to prescribe structures or methods of working within institutions. Instead, it should encourage transparency and meaningful reporting around the internal governance of the institutions. High quality reporting and meaningful explanations will allow clients to judge the level of integration and allow this to be taken into account when allocating mandates.

We consider that the Code, if applied as originally promulgated when under the auspices of the ISC, will help to rebuild the critical mass of engaged shareholders and improve the dialogue between investors and companies. Given this, we believe that the FRC should have an oversight role in relation to the Code, but allow the ISC to be responsible for the content and development of the Code. The effectiveness of the Code should be monitored in a high-level manner, which tracks market developments. It should not seek to judge individual explanations. The judgement of explanations should be left to individual clients. This is in line with the Combined Code, where investors are left to judge explanations, not the FRC or others.

We would also stress that there should be one primary market monitoring mechanism. If various monitoring systems or surveys develop, then institutions are in danger of spending their time responding to these rather than discharging their responsibilities.

Section 2 – Background and Recent Developments

The ISC Code represented a first in terms of investor responsibilities being set in a national context. However, the International Corporate Governance Network did set out its Statement of Principles in Institutional Shareholder Responsibilities in 2007. These principles provide a useful benchmark for the present Code and how it will be viewed internationally.

In the ABI's capacity as the Secretariat of the ISC, we are pleased to report that there has been significant interest from overseas investors in the ISC Code. The interest has come from a variety of organisations, including public sector pension funds, mainstream institutional investors and sovereign wealth funds. We consider this to be *prima facie* evidence that there is an interest for an appropriately formulated Code. However, we would stress that the interest in the ISC Code was in the context of it being a voluntary standard and that there is a significant danger

that overseas investors will not submit to anything is perceived as UK regulation with its associated burdens. This is particularly important when considering the need for any independent verification, such as AAF0106.

We would also caution of the dangers and unintended consequences that may arise if the Code becomes too compliance driven. For example, the ERISA legislation in the US requires that pension funds discharge their voting responsibilities. Whilst there are many US pension funds who do this conscientiously and in a considered way, the legislation has also caused many to outsource voting activity or always support management. The effect therefore has been to cause voting levels to rise but not resulted in those voting always discharging their responsibilities properly. In effect, the rise in voting has not led to a rise in responsible ownership.

Section 3 The Coverage of the Code

ABI members were supporters of the ISC Code and indeed they have for a number of years applied the ISC's Principles on which the Code was based. They already publish significant amounts of information on their approach to governance and stewardship on their websites and directly to clients. However, the proposed Stewardship Code still represents a step change in terms of how investors approach the issues covered. Therefore, there must be a sensible time-frame for implementation, with individual investors being able to implement it on a gradual basis. In a similar vein, the Code should be allowed to bed down over a number of years before any substantial review is conducted. This approach will allow best practice to evolve in the market. This in our experience is a more productive approach to issues around governance. We would point to the way corporate governance has evolved in the UK from the Cadbury Report onwards as an example of incremental improvements building on sound core principles leading to an effective framework.

We do not believe that the principles set out in the Code can be applied in any meaningful way to either proxy voting agents or investment consultants. Both voting agents and consultants act as advisors to their clients and not as principals themselves. As already highlighted in the Code's guidance, where an institutional investor or asset owner outsources voting decisions to agents, this should be disclosed as it represents a devolving of fiduciary responsibility.

Although the Code may not be directly applicable, we would expect both voting agencies and investment consultants to support its intentions and take account of it when making decisions. We also believe that there should be consideration of how their activities influence the ownership chain and what steps could be taken to ensure their activities are properly governed. For example, comply-or-explain cannot work if the explanations are not considered properly in the context of the company. Blindly outsourcing voting responsibilities represents in our view an abrogation not an enhancement of ownership responsibilities.

The ability of foreign shareholders to play a responsible ownership role will be influenced by their ability to receive information and vote. There remains a

significant problem in the custody chain when investing cross-border in terms of both receiving information and exercising the vote. The European Commission has begun a consultation on a Securities Law Directive which may address this issue. We would urge that parties interested in shareholders exercising their ownership responsibilities take an active part in the consultation process to ensure that the final Directive reflects the needs of investors in this regard.

The interest from overseas is to be welcomed. However, it also raises some potential problems. The Code as envisaged applies to UK listed companies, but some investors may wish to apply the principles on an international basis, whilst other jurisdiction may look to introduce their own Codes. This could lead to a proliferation of Codes, which would cause problems for international investors when considering how to behave in different markets and what to report. We therefore believe consideration should be given to how this would work in practice. There could, for example, be scope for mutual Code recognition or a passporting of Codes.

Section 4 Content of the Code

We believe that the content of the Code is sound. It draws heavily on the ISC Principles, which represent the views and experience of the institutional investors. The Principles properly balance the need for responsible ownership by investors with the natural constraints of their role. We believe that any radical changes to the Code would discourage investors from applying it and consequently defeat the primary goal of rebuilding the critical mass of engaged shareholders.

One point that was raised regarding the ISC Code by overseas investors was that, to an extent, it lacked context. The Code focuses on process, but does not directly refer to the issues around which these processes are to be applied. For example, the Combined Code is only referenced twice and in neither case is it clear that it represents best practice in relation to corporate governance. Whilst this does not cause a problem for UK investors, with their experience and exposure to it, it may be helpful for overseas investors if the preamble set the Code in the context of the UK market's practices and architecture.

Section 5 Reporting, Monitoring and Review

We believe that a level of public disclosure in relation to the Code is necessary. This disclosure should enable clients and potential clients to assess the institutional investors' policy and approach. It will also allow listed companies to better understand the way in which issues of stewardship are approached by their shareholders and consequently improve engagement.

The public disclosures should be made against the Code's principles on a comply-or-explain basis. Over time a combination of developing market practice and client demand should result in the disclosure becoming ever more informative and best practice standards evolving. We are opposed to best practice disclosure standards being imposed at the outset. This would lead to either boiler plating or a reluctance

from investors to sign up to the Code. Neither outcome would promote effective stewardship.

The activities relating to Stewardship can be sensitive, with engagement activities relating to confidential issues. We therefore believe that the public disclosures should be in the form of general statements around the policies and approach of the institution. They should not be around specific activities relating to individual companies. In the case of disclosure to clients, this should remain a matter for contractual agreement between the two parties. We would note that our members do regularly discuss with clients company specific engagement activities and voting.

We believe that the disclosure relating to the Code should be a separate discipline from other existing practices. Current disclosure regimes, particularly relating to SRI such as the UNPRI, do not have the universal recognition or appliance that the Code should aspire to. Such initiatives are heavily focused on one part of corporate engagement, whereas the Code's focus on creating long-term sustainable value is much broader. We therefore believe that any attempt to harmonise disclosures would result in some investors being unwilling to sign up to the Stewardship Code.

Within an investment organisation there frequently exists a variety of different funds. These funds will have different investment styles, objectives, time horizons and clients, and these styles may differ considerably from each other. For example, an investment house may operate a tracking fund, another which is "quant-driven", i.e. that involves mathematical models to pick stocks, and another which can be long-short on stocks picked by a fund managers. These differing styles will inevitably lead to differing approaches to stewardship. We do not believe it would be practical for the disclosure against the Code to be at each individual fund level. Instead we believe that the disclosures should relate to the overall house approach and should make clear that individual funds operating within the organisation may differ. When entering into mandates with clients, the institution should highlight if and why the approach to stewardship would vary from the disclosed prevailing house approach.

The monitoring of the Code is an important element in ensuring it is a success. Subject to having appropriate independent checks and oversight, we believe that the IMA survey would be an appropriate mechanism for market monitoring. We believe that such monitoring should have the aim of assessing the market's performance as a whole and not seek to judge individual disclosures or performance. Qualitative judgement on individual institutions' performance or disclosures should be left to the clients/asset owners, with market mechanism being the appropriate enforcement method. We also believe that there is a danger of monitoring overload, with institutions being deluged with surveys and questionnaires, which require resources to respond to that would be better directed at good stewardship. We would therefore urge that there be one publicly available officially recognised survey which institutions would respond to.

The ISC Code recommended that institutions should consider obtaining an independent audit opinion on their engagement and voting processes having regard to the standards in AAF 0106 and SAS 70. Our members strongly believed that in

order for the Code to be credible independent verification was necessary for UK institutions. We understand that the FRC has convened a group to look at how AAF0106 could be reformed to cover the Stewardship Code on the basis of verifying process, not outcome. Subject to this group reaching satisfactory conclusions, we would support the continuing use of AAF0106 (or similar standards) as a method of obtaining independent verification.