



Ms Susannah Haan

Financial Reporting Council
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Dear Ms Haan,

Consultation on a Stewardship Code for Institutional Investors

ACCA (the Association of Chartered Certified Accountants) is pleased to respond to the Financial Reporting Council (FRC) consultation on a Stewardship Code for Institutional Investors.

ACCA is the largest and fastest-growing global professional accountancy body with 131,500 members and 362,000 students in 170 countries. We aim to offer the first choice qualifications to people of application, ability and ambition around the world who seek a rewarding career in accountancy, finance and management. ACCA works to achieve and promote the highest professional, ethical and governance standards and advance the public interest.

Our comments below are based on the considerations of ACCA's technical Business Law and Corporate Governance and Risk Management Committees.

Overall

We are pleased that the FRC has decided to consult on this matter. It is important, not just for the quality of corporate governance but for the future of our capital markets and for the security of many people's savings for pensions and investments, that efforts are made to encourage major investors to make constructive use of the ownership influence that they undoubtedly have. Any additional encouragement that investors can be persuaded to give to companies to focus on long-term shareholder value will also be a very helpful development. We therefore welcome the attention being given by FRC to this matter and encourage it to develop this project further.

The consultation document provides a helpful re-statement of the issues that need to be explored in the course of developing the proposed new framework. We do, however, have some concerns about the scope of the new Code, its content and its likely efficacy. We consider that the scope could usefully be expanded so as to address, additionally, the stewardship responsibilities of institutional shareholders to those who entrust their money to them. We consider also that the Code should define more clearly what it means by 'stewardship' and the responsibilities of institutional shareholders: coverage of the latter could usefully benefit from a cross-referral to the legalities of share ownership. As with the Combined Code (on Corporate Governance) itself, there is a fundamental issue of whether the new Code can be effective in terms of improving behaviour if there is to be no enforcement mechanism.

Our comments below expand on a number of matters regarding the content of the Code. They are intended to be constructive but reflect our concerns about certain aspects of the proposed Code.

Scope

The term 'stewardship' can have many meanings and it is not defined in the document. One definition of 'steward' is 'a person who administers the property, house, finances etc of another'. Taking this meaning, institutional shareholders are stewards of the money entrusted to them by people who want their investments professionally managed or saving for their pensions. The hope of these people is that their money will be both safe and grow steadily in value, without high volatility, over the long term. 'Stewardship' is used widely and with good reason to refer to the undisputed responsibility of boards of directors to look after the interests of their companies. A board is the steward for the assets of a company which is owned by shareholders.

The focus of the proposed Stewardship Code is essentially on the engagement by institutional shareholders with boards. In this light the term 'stewardship' seems to us to be potentially misleading, and misses the point about institutional shareholders' wider fiduciary responsibilities. A different term should be used. We would also like to see more emphasis placed on those wider responsibilities.

In this connection we would make the general point that the financial crisis has highlighted the extent to which society can be adversely affected by the

activities of companies. Clearly, regulation cannot always be relied upon to protect the interests of stakeholders so it is right that those stakeholders should be encouraged to use whatever rights and powers they may have to protect their own interests. And given that institutional shareholders invest money on behalf of millions of people, it must be seen as appropriate that they approach their consideration of 'shareholder value' in a way which is rooted in an appreciation of the long term and which does not conflict with the other legitimate interests of society or the environment.

This is therefore perhaps an opportunity for institutional shareholders to do more to build public trust. The Code could go further in highlighting the benefits to shareholders of greater engagement on matters of concern to their fiduciaries and a wider range of stakeholders.

Content

The following paragraphs set out some points about particular aspects of the content of the document and Code.

(i) Terminology

In our opinion, the consultation document does not accurately represent the legality of the role of investors with respect to the companies in which they invest. Shareholders have legal rights, but no legal responsibilities, in relation to their company. These rights are created in order to enable them to protect their interests, but whether they exercise these rights or not is up to them. In suggesting, as the paper does, that shareholders are 'expected' to take action in particular circumstances, or that investors have any responsibilities to do so, the Code should make it clear that these are expectations based on a perceived moral duty (to those who entrust money to them) rather than a legal duty.

(ii) The status of engagement

Following on from the above point, and without suggesting that active engagement should be mandatory, we believe the new Code should make the case for why institutional shareholders should consider active engagement to be in their interests and to be consistent with their own fiduciary obligations to their stakeholders.

It would be helpful in this context for there to be also an acknowledgement of the expansion of the scope of directors' duties under the Companies Act 2006

so as to encompass a wider range of stakeholder concerns. The Act confers a duty on directors to promote the success of their company and, in the course of making their decisions to that end, they must 'have regard' to the following:

- i. The likely consequences of any decision in the long term
- ii. The interests of the company's employees
- iii. The need to foster the company's business. relationships with suppliers, customers and others
- iv. The impact of the company's operations on the community and the environment
- v. The desirability of the company maintaining a reputation for high standards of business conduct
- vi. The need to act fairly as between members of the company.

As noted above, the funds managed by institutional shareholders come from millions of people. Institutional shareholders should therefore recognise that they, as well as boards, have societal obligations even if these are moral and not legal. As shareholders are the only group who could attempt to enforce these directors' duties, we would like to see the Code put the case for active engagement in this context. This should also help to correct what has become an ingrained focus on short term value by many shareholders.

The current version of the Code says simply that institutional shareholders are free to choose whether or not to engage with investee companies. We fear that presenting the issue in this way risks giving too much encouragement to investors to decide to avoid engagement altogether. While we do not suggest that the Code should dictate behaviour to investor groups, we think it could do more to set out the case for why active engagement should, in principle, be seen as in the interests of institutional shareholders and their own stakeholders.

(iii) The motivation for engagement

Shareholders can hardly argue they have always been served well by management in recent years. And they could rightly say that the processes put in place to provide assurance to them did not identify deep underlying problems, where they in fact existed. Many shareholders are currently not experiencing the returns they want and many are seeing large write-downs in company value. Those who rely on long-term returns are obviously interested in long-term performance, so it is very much in their financial interest to engage with boards to ensure that they too focus on the long-term.

We would argue also that shareholders who do not engage with their investee companies benefit from engagement by shareholders that do. This 'freeloader' problem is well known, but is in each institutional shareholder's own interest to demonstrate to those who entrust money to them that their engagement activity is working in their fiduciaries' wider interests. Public confidence and trust in the investment industry could be better and should be improved through better and more transparent engagement. The institutional shareholders who demonstrate responsible engagement taking proper account of the interests of their fiduciaries should stand to benefit most from restoration of trust.

Such engagement should also entail a stronger interest in corporate social responsibility and sustainability. All organisations should be interested in these wider concerns and not just in financial returns. (These issues now, of course, form part of directors' expanded statutory duties). Financial returns will of course remain the prime focus and accountability of institutional shareholders, but investors should not be unaffected by the general trend towards a wider embracing of the needs of society, the environment and the long-term health of companies and the economies they support. Investors should accordingly see themselves as playing an important role in promoting the long term benefits of sustainability.

(iv) Involvement with management

The Code currently states that investors should not seek to micro-manage investee companies. This is an unfortunate choice of phrase: external shareholders should not seek to 'manage' investee companies in any sense. The code might also usefully guard investors against seeking to exert excessive influence on company boards, and refer to the danger of being regarded as shadow directors.

(v) Internal motivations for engagement

The Code focuses primarily on the approach taken by institutional shareholders in dealing with investee companies. There is comparatively little in it on how shareholders might or should manage the internal relationships with their beneficial stakeholders so as to ensure that whatever representations are made to investee companies are representative of the concerns of beneficiaries.

Many investors, institutional and otherwise, are motivated by their own, often short-term, economic interests when dealing with investee companies. This has the potential to impose unhelpful pressures on boards, pressures which may

lead to decisions being taken which are not in the best long-term interests of the company concerned. It would be helpful if the Code could say something about this matter and emphasise that, while shareholders are entitled to think in a self-interested way, they must respect the fact that directors have a responsibility to act in what they regard as being the best and long-term interests of the company as a whole. Accordingly, the Code could make the point that the process of shareholder engagement should take place in the context of a mutual awareness of the respective positions of shareholders and boards on this issue.

Efficacy

The consultation paper, in its introduction, says that shareholders are ‘expected to judge the explanation’ of companies’ statements on whether they comply or explain compliance with the Combined Code provisions. As stated above, this does not accurately reflect the legal position of shareholders. Nor does it take account of the other Combined Code requirement which is for companies to state how they apply the Combined Code’s principles. The consultation paper is right in saying that ‘the effectiveness of this approach (*comply or explain*) depends on sufficient investors being willing, directly or indirectly, to put resources into engaging actively with the companies in which they invest’. High corporate governance standards cannot be enforced unless shareholders are both willing and able to apply sufficient influence on boards so that they can be held properly to account. Based upon events over the years, but particularly those affecting the banking sector recently, experience suggests that, too often, boards have not been properly held to account. Although some institutional shareholders have made commendable efforts to influence companies in the right direction, successes in this area have been regrettably few.

Given this experience, we believe that, in the drafting of the new Code, there needs to be a greater sense of realism as to what concerned shareholders can achieve in terms of governance. Shareholder bodies in major companies are extremely diverse and characterised by a lack of coherence, and consequently there may be only so much that any shareholder in a large listed company can do to hold the board of directors properly to account. Shareholders can, and in many cases arguably should, ensure that they engage with investee company boards where to do so is consistent with their own fiduciary responsibilities, but ultimately it is for boards to make decisions on the direction of their companies and essentially all shareholders can do, in a governance sense, is to make appropriate representations. Accordingly, we consider that the overriding emphasis in the Code should be on causing major investors to think about why

it is that they should consider active engagement with investee boards and encouraging them to frame their engagement strategies in a way which takes into account not only their own rights as owners but the legal responsibilities of the directors.

ACCA responses to the FRC Issues for Comment

Quotations from the consultation paper are in italics

Section 1: Introduction

The FRC would welcome views on the policy objectives against which the FRC should judge its approach to a Stewardship Code (paragraph 1.14), the proposed objectives being to:

- Set standards of stewardship to which mainstream institutional investors should aspire, and maintain the credibility and quality of these standards through independent input on the content and monitoring of the Code;*
 - Promote a sense of ownership of the Code amongst institutional investors in order to encourage UK and foreign shareholders to apply and report against it;*
 - Ensure that engagement is closely linked to the investment process within the investment firm;*
 - Contribute towards improved communication between shareholders and the boards of the companies in which they invest;*
- and*
- Secure sufficient disclosure to enable institutional shareholders' prospective clients to assess how those managers are acting in relation to the Code so that this can be taken into account when awarding and monitoring fund management mandates.*

ACCA Response

We support the policy objectives. As stated above, we regard this issue as being very important for corporate governance and for the operation of the markets.

However, as already explained, we have reservations about the use of the term 'stewardship' in this context and believe the Code should relate better to how institutional shareholders fulfil their fiduciary responsibilities to their beneficiaries. These fiduciary responsibilities are not satisfied simply by '*disclosure to enable institutional shareholders' prospective clients*' as not all clients (particularly retail savers) have the capacity, in terms of knowledge, experience or resources, to act on such disclosures or hold institutional

shareholders to account. If the primary focus of the Code is to be on engagement between shareholders and boards, it should be given a more suitable name.

As set out above, we consider more could be done to promote a sense of ownership of the Code amongst institutional shareholders, including articulating the benefits of its adoption.

The FRC is seeking views on whether it should accept oversight of the Code in its current form, or whether amendments should be made before the FRC does so (paragraph 1.16).

ACCA Response

As is implied by the rest of our response to this consultation, we consider amendments are required before the FRC accepts oversight of the Code.

Views are also sought on which institutional investors and agents should be encouraged to apply the Code on a “comply or explain” basis, what they should be asked to disclose and to whom, and the monitoring arrangements that should be put in place (paragraph 1.17).

ACCA Response

The seven principles are high-level and reports would be most informative if reporters stated how they have applied each of the principles. Of the options given in paragraph 5.9 of the consultation paper, we therefore suggest that the most useful would be:

‘A statement of how the firm has applied the principles within the Code, in a manner that would enable their clients to evaluate how the principles have been applied, with an explanation of non compliance against each of the principles where applicable.’

Given the emphasis on application rather than compliance, the term ‘apply and explain’ would be more appropriate than ‘comply or explain’.

Section 2: Background and Recent Developments

The FRC would welcome any insights on lessons which may be learned from experience outside the UK (paragraph 2.18).

ACCA Response

As a global accountancy body, ACCA is familiar with practices around the world. The shares of UK and American companies are generally much more widely held than in other countries meaning that individual shareholders generally have less control and tend to have a shorter term investment horizon. The UK is also very different from other countries in its laws and customs and practices (including hedging and shorting strategies). Therefore, in our view, the UK is a unique case when it comes to shareholder engagement.

Section 3: The Coverage of the Code

The FRC would encourage all UK institutional investors to apply and report on the Code regardless of whether or not they are subject to mandatory requirements, and would welcome views on whether there are any barriers or other reasons that would prevent or discourage them from doing so (paragraph 3.6).

Views are invited on whether agents such as voting services agencies and investment consultants should be encouraged to commit to the spirit of the Code, and if so how this could be done (paragraph 3.8).

The FRC is keen to hear from foreign investors in response to this consultation, and would in particular welcome comments on:

- Whether foreign investors would be willing voluntarily to commit to a code sponsored by a UK regulator such as the FRC or a UK industry body like the ISC in respect of their holdings in UK companies;*
- Their current practice on disclosing information on their engagement policy, including any national or international standards they follow; and*
- Any barriers or other potential difficulties for foreign shareholders seeking to engage with UK companies (paragraph 3.13).*

The FRC would also be interested to hear from investors who operate on a cross-border basis about any potential conflicts which might arise between requirements or codes in place in other countries and the proposed Stewardship Code (paragraph 3.14).

ACCA Response

As we have suggested, and for the reasons set out, above, we believe that the Code could better set out the benefits to institutional investors of adopting it. It is unfortunate that there is unlikely to be any mechanism which can ensure adoption of the Code and high quality of disclosure of how its principles are applied. Active enforcement by the FRC may be the only option but it would be

important, if difficult, to ensure that this did not produce a tick-box compliance response which would be counter productive.

Section 4: The Content of the Code

Respondents are welcome to comment on any aspect of the ISC Code, but in particular views are invited on these questions:

What are the responsibilities for engagement of institutional investors to the beneficial owners whose interests they represent? Does the ISC Code cover all the relevant responsibilities?

ACCA Response

As explained above, the Code certainly does not cover all the responsibilities of institutional shareholders to beneficial owners. Arguably, it does cover their fiduciary responsibilities for their engagement with companies. This, however, is only a small part of their wider fiduciary responsibilities.

What are the responsibilities for engagement of institutional shareholders to the UK listed companies in which they invest? Does the ISC Code cover all the relevant responsibilities?

ACCA Response

Legally, institutional shareholders have no responsibilities to companies in which they invest. However, as pointed out elsewhere, they have fiduciary responsibilities to their savers and investors and, in our view, wider societal responsibilities. These non-legal responsibilities do confer a moral obligation on institutional shareholders for constructive engagement with companies.

Are the respective responsibilities of the different parts of the investment chain sufficiently clear and appropriate?

ACCA Response

No. The Tomorrow's Company report 'Investment in the Twenty First Century', published in 2004, set out the complexities in the investment chain, the inherent conflicts of interest, lack of transparency and the scale of what should be done. Little has changed since. The Code makes only brief allusion to this in

Principle 2. The three sentences of guidance supporting the principle are, in our view, not sufficient to address such a fundamental issue.

- Does the Code strike the right balance between the need to avoid overspecification that might discourage the application of the Code and the need for it to be effective with an appropriate degree of transparency?*
- Are there any parts of the ISC Code where further guidance is needed, or where the existing guidance should be amended? (paragraph 4.2)*

ACCA Response

Guidance should be given on the full range of institutional shareholders' fiduciary responsibilities.

Views are invited on whether the ISC Code adequately covers the content of Section E of the Combined Code (paragraph 4.4)

ACCA Response

Principle 3 should be extended so as to encourage institutional shareholders to pay close attention to disclosure by companies of how they apply the Combined Code principles and use these disclosures as a basis for engagement.

Section 5: Reporting, Monitoring and Review

The FRC would welcome views on:

- *The information that institutional shareholders should disclose publicly and that they should report to clients;*
- *The arrangements that should be put in place to monitor how institutional shareholders apply and report against the Code; and*
- *The arrangements for reviewing the operation and content of the Code (paragraph 5.2).*

The FRC would welcome views on the specific information that should be disclosed by institutional shareholders and their agents, and at what level of detail the "comply or explain" principle should apply (paragraph 5.3).

Views are invited on whether public disclosure of the information summarised is appropriate and useful, and whether other information might also usefully be disclosed (paragraph 5.6).

Views are invited on the structure of the ISC Code and on the best way to

encourage reporting against it on a “comply or explain” basis (paragraph 5.10).

ACCA Response

As set out above, institutional shareholders should disclose how they apply the Code principles. They should avoid any tendency to ‘boiler plate’ and set an example to companies of the quality of disclosure they would like to see in governance reports by companies. The guidance should therefore make the case for meaningful disclosure.

Views are invited on the proposals in the ISC Code for reporting to clients and the merits of independent opinions from auditors or other professional accountants. It would be helpful to have estimates of the costs incurred by asset managers in commissioning these opinions and of the benefits to asset owners (paragraph 5.14).

ACCA Response

We think there is potential in this idea but suggest that the FRC initially undertakes a study of whether there is any demand for such a professional opinion and on the possible costs and benefits. Any opinion is likely to have to focus on readily verifiable aspects of the engagement process and is unlikely to be able to give an opinion on the effectiveness of the engagement process.

Views are invited on the merits of the current IMA survey and other possible approaches to monitoring the overall application of the Code (paragraph 5.21).

Views are invited on the proposed approach to reviewing the Code (paragraph 5.22).

ACCA Response

We are concerned that there will not be any effective means for anyone to enforce the Code. What is needed, ideally, is a mechanism by which fiduciaries can hold institutional investors to account.

Concluding Remarks

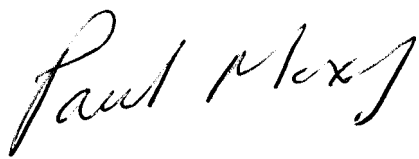
To reiterate, we very much welcome the attention being given by the FRC to the encouragement of major shareholders to take an active interest in the affairs of

their investee companies. The involvement of major shareholders in company affairs is without question a key element of corporate governance and it is right that efforts be made to try to improve the effectiveness of this involvement for the benefit of all concerned. We have made a number of suggestions in this response for how the FRC's proposed approach might be improved so as to be more likely to achieve the agreed objective.

The main point we would like to make, in conclusion, is that if the Code is to make the desired difference, then it must engender among the investment community an enhanced recognition on its part of the virtue of defending and promoting the long term interests of the ultimate stakeholders in company affairs, namely those beneficial shareholders whose savings and investments are managed by the big institutions. Such interests include community and environmental matters as well as financial considerations. And if those institutions are to become more active in this direction they should be encouraged to do so in a way which combines legitimate fiduciary concern with a constructive understanding of the respective roles of investor and board. Therefore the Code should, in our view, be drafted in a way which will be seen by investor groups not so much as a new compliance exercise but as a facilitator of helpful engagement with the process of governance.

We would be pleased to discuss any aspect of this response with you at your convenience

Yours sincerely



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