

# Consultation on a Stewardship Code for Institutional Investors

## Submission from The Association of Investment Companies

The Association of Investment Companies (AIC) welcomes the opportunity to respond to the FRC's consultation on a Stewardship Code (Code) for institutional investors.

The AIC is the trade association representing the closed-ended investment company industry. Its membership comprises of some 345 investment companies with £68 billion of assets under management. The AIC brings a unique perspective to this agenda as investment companies are both institutional investors and issuers.

A critical goal of developing an FRC backed Stewardship Code will be to improve the quality of engagement and voting decisions. This should include linking these processes with investment decisions. With this in mind, we note that the AIC Code of Corporate Governance, which has been recognised by the FRC as a means by which investment company boards can meet their obligations under the Combined Code, recognises the importance of corporate governance and engagement.

The AIC Code says that investment company boards should agree with their external manager a policy on voting and corporate governance issues in respect of holdings in the company's portfolio. It says that this policy should take account of the Institutional Shareholders' Committee 'Statement of Principles' on shareholder engagement. This recognises the importance of this agenda. (We are of course aware that the Statement of Principles has been superseded, and we will recognise this when the AIC Code is next updated.)

### Executive summary

The AIC agrees that the FRC should have oversight of the stewardship responsibilities of institutional investors. The AIC also agrees that the ISC Code should form the basis of a new Stewardship Code which will operate on a 'comply or explain' basis.

The AIC's key **recommendations** are as follows:

- The FRC's policy objectives should be more outcome-focused. They should recognise that at the heart of engagement is a desire to achieve better investment returns for shareholders, improve the investment process and communication between investors and companies. The FRC should also seek to make the Stewardship Code as comprehensive as possible i.e. there should be an objective of bringing as many parties as possible into its coverage. This should include, for example, corporate governance agencies.

- The FSA should stipulate that regulated investment firms should only be allowed to outsource to external governance agencies which have committed to applying the Stewardship Code on a comply or explain basis.
- The FRC should determine the content of the Code, which should be reviewed and updated on a periodic basis.
- Parties which have signed up to the Stewardship Code should publish an annual statement of their compliance with the Code, setting out how they have complied with each of the Code's principles and associated guidance, and provide an explanation of areas of non-compliance. This statement would 'mirror' the annual disclosure on governance made by companies in terms of its length and detail.
- The FRC should host a central 'register' on its website of those entities applying the Stewardship Code and provide a facility to link the user to the entity's 'comply or explain' statement and any other relevant policy statements and disclosures.
- A new principle should be added to the Code which addresses the responsibilities of governance agencies.
- Further guidance should be included in principle 3 of the Code to encourage institutional investors to give greater consideration to explanations provided by companies.
- The Stewardship Code should not be subject to assurance reports provided by independent auditors.

### **Policy objectives**

It is useful to create policy objectives against which to judge the Stewardship Code. The AIC **recommends** that these are published as part of an introductory section to the new Stewardship Code. However, the proposed policy objectives should be made more outcome-focused and emphasise the intended benefits from adopting the Code's principles. They should be direct, clear and understandable. The AIC **recommends** that the policy objectives against which to judge the Stewardship Code should be rewritten as follows:

- to enhance the quality of dialogue between institutional investors and companies with a view to improving long-term returns, reducing the risk of catastrophic outcomes due to bad strategic decisions and enhance governance
- to ensure that engagement is closely linked to the investment process
- to improve communication between shareholders and boards
- to maximise the number of institutional shareholders and third parties (including corporate governance agencies and overseas investors) that 'comply or explain' against the Code
- to provide a mechanism for beneficial owners to assess the effectiveness of agents acting on their behalf.

Achieving better investment returns for shareholders is not currently included in the draft policy objectives, although it is discussed in the introductory section of the ISC Code. It should be one of the underlying objectives of

engagement between shareholders and boards and flow throughout the investment chain. Investment managers make 'buy/sell' decisions with the aim of maximising returns for their clients. Boards have a responsibility to deliver the long-term success of the company. Stewardship and engagement should recognise investors' fundamental goal of achieving better returns for beneficial owners and this should be clearly prioritised in the Code's policy objectives.

Prominence should be given to linking engagement with the investment process. Those responsible for the day-to-day investment decisions should be involved in any stewardship activity relating to investee companies. This includes situations where stewardship functions are outsourced to third parties, for example corporate governance agencies and where investment firms have their own dedicated governance departments.

The importance of effective interaction between shareholders and boards of investee companies should also be highlighted more clearly in the Code's policy objectives. This recognises that engagement is not a one-sided process – both parties have to meet their obligations if it is to provide value.

### **Oversight of ISC Code in its current form**

The AIC **recommends** that the FRC should accept oversight of the ISC Code. It should:

- determine what changes need to be made to the content of the Code (following consultation)
- commit to reviewing and updating the Code on a periodic basis in the future
- host a central 'register' of institutional investors and agencies adopting the Code
- provide a facility on this register to link the user to the 'comply or explain' statement published by each investor or third party applying the Code as well as to any other relevant policy statements and disclosures
- review the environment in which engagement is being undertaken to ascertain if changes are needed to the content of the Code.

There are a number of ways in which the current version of the ISC Code should be improved. These are discussed under 'Content of the Code' below. These changes should be made by the FRC before its new Stewardship Code is published.

### **Coverage of the Code**

Many institutional investors outsource engagement and voting issues to third parties. This is an important process and may represent an increasing part of the engagement agenda, particularly as this area comes under more scrutiny and investors seek to discharge their obligations in a cost-effective manner.

The ISC Code does not currently explicitly cover the use of agencies and this should be addressed.

The AIC **agrees** that all UK institutional investors and their agencies should be encouraged to apply and report against the new Stewardship Code regardless of whether or not they are subject to mandatory requirements.

The AIC is aware that the FSA is currently considering the introduction of disclosure requirements in relation to the Stewardship Code and will respond to its consultation in due course. We **recommend** that firms regulated by the FSA should only be allowed to outsource to corporate governance agencies which have committed to comply or explain against the Stewardship Code.

The AIC **agrees** that foreign investors should be encouraged to commit to the Stewardship Code on a voluntary basis.

### **Content of the Code**

The AIC **agrees** that the ISC Code should be used as the basis for the Stewardship Code. However, there are a number of ways in which the ISC Code should be improved by the FRC before it is re-launched as the Stewardship Code. These are discussed below.

- Governance agencies

The introductory section of the ISC Code states that the use of the term 'institutional investor' should include any agents appointed to act on their behalf, which would include governance agencies. However, it does not currently contain any specific recommendations in relation to the practices employed by these agencies, particularly in relation to engagement.

There have been a number of occasions over the last few years where investment company boards have encountered problems when dealing with governance agencies.

On occasions, our members have felt that governance agencies automatically label any deviation from the Combined Code with a negative assessment of the company's governance arrangements. They also report that insufficient consideration is given to explanations of non-compliance provided by the board.

Also, on some occasions, boards have not been informed that a negative view is being taken about their compliance arrangements and have not been given sufficient opportunity to make an effective response (we are aware of cases where companies have been given less than 24 hours to respond). When they do try to engage with the agency, they have encountered difficulties in finding an appropriate point of contact, or one sufficiently senior to receive and act on an explanation. We are also aware of examples of factual errors by agencies which should be a simple matter to correct but where a correction

has not been possible because of a lack of time or no suitable contact point being available.

There have also been instances where the board has contacted the person within the investment firm making the investment decision who has agreed that the shares should be voted in a certain way, only to discover that the agency had taken a different view and ultimately the shares have been voted in line with the agency's recommendation.

Ill-considered negative assessments can have detrimental effects. For example, they create unnecessary concerns amongst investors, attract unhelpful media attention and could potentially lead to shareholders voting unjustifiably against the board, for example on director re-election.

The AIC therefore believes that the FRC should address the role of voting agencies in the Stewardship Code. It **recommends** that the Code should include a specific principle, with more detailed guidance, on the responsibilities of voting agencies. Suggested wording is as follows:

**Principle x: Agencies appointed to act on behalf of institutional investors, including corporate governance agencies, should be transparent and where required, be willing to pro-actively engage with companies whose practices they are assessing.**

Guidance

In discharging their stewardship and engagement responsibilities, agencies should:

- publish any voting policy which supplements the UK Code of Corporate Governance (the Combined Code) at no charge.
- explain the processes applied to assessing companies and making voting recommendations to clients and the companies monitored. This should be annually updated and published.
- allocate sufficient resources to ensure that a qualitative, rather than mechanistic, assessment is made of a company's governance arrangements, and disclose details of the resources applied.
- disclose the average amount of time spent analysing each company, including reviewing the annual report and accounts (a distinction could be made between FTSE 100 and other companies).
- establish processes for communicating with companies in advance of making a negative assessment.
- give companies a reasonable timeframe (at least 3 working days) to respond to recommendations which do not support a vote in favour of resolutions and the basis of such recommendations before submitting them to clients.
- have in place procedures for receiving representations and publish contact details where queries can be directed.

- submit company assessments and voting recommendations to those individuals within the client's organisation who are responsible for making investment decisions.
- publicly disclose all voting recommendations after the relevant general meeting.
- publish client lists.

This recommendation has taken account of PIRC's five 'Principles of Best Practice for Proxy Voting and Corporate Governance Advisers' published in January 2010.

The AIC also **recommends** that the FRC undertakes additional research on the activities of voting agencies to understand more about how they operate. This research should seek to understand company experiences of dealing with such agencies. (It is possible that smaller or specialist companies face more issues in this area than, say, FTSE 100 companies.) This research should be published to inform a public debate on agencies and engagement and to inform any further review of the Stewardship Code.

- Obligation to issuers to fully consider explanations

The AIC **recommends** that the Stewardship Code creates an obligation for institutional investors to carefully consider explanations provided by companies. This is a critical element of the engagement process.

This could be achieved by incorporating the material from supporting principle E.2 of the Combined Code into the Stewardship Code. Also, the Stewardship Code should encourage institutional investors to provide details of how engagement on explanations can be pursued.

- Section E

In relation to Section E of the Combined Code, the AIC makes the following points:

- We **agree** that the text of the ISC Code is clearer than Section E with regard to the basis for dialogue between the company and its shareholders. Therefore, there is no need to include main principle E.1 from the Combined Code in the ISC Code.
- The provisions in Section E about attendance of major shareholders at AGMs should not be incorporated into the Stewardship Code. It should not be expected that institutional shareholders attend AGMs as a matter of course.

## Reporting, monitoring and review

### Publicly available reporting

The 'comply or explain' regime applied to the Stewardship Code should mirror the obligations for reporting against the Combined Code. In other words, the AIC **recommends** that those parties which have signed up to the Stewardship Code should publish an annual statement of their compliance with the Code, setting out how they have complied with each of the Code's principles and associated guidance during the period under review, and provide an explanation of areas of non-compliance. This will provide clients with sufficient information with which to assess the quality of the engagement activities which have been undertaken. It should also provide sufficient flexibility for investors to adapt the Code to their particular circumstances. In this case, a short disclosure can be made explaining why engagement is not undertaken.

The AIC also **recommends** that the compliance statement should contain a discussion of any key issues relating to engagement in the relevant period, as well as the disclosures which are required to comply with the Code, for example, the obligation under principle 5 for institutional investors to *"disclose their policy on collective engagement"*.

When making their compliance statements, agencies should include a list of the clients they have worked for in the relevant period.

The disclosure statement should cover a specific twelve month period. This might be the same as the company's accounting year, but, as stewardship responsibilities are not directly linked with financial reporting, the reporting entity may select a different period. The AIC **recommends** that there should be an obligation to publish compliance statements on the Code within four months of the end of the relevant twelve month period. This is in line with the timetable for companies to disclose their corporate governance statements in relation to the Combined Code under the Disclosure and Transparency Rules.

As stated above, the AIC also **recommends** that the FRC maintains a register on its website of those following the Stewardship Code which contains a direct link to each entity's 'comply or explain' statement.

### Reporting to clients

The AIC continues to support the approach taken in Principle 7 of the ISC Code that the particular information reported to clients *"should be a matter for agreement between agents and their principals"*.

The AIC has concerns about any suggestion that investors who sign up to the Stewardship Code must obtain an independent opinion from an auditor on their engagement and voting processes. Assurance reports, based on assurance reporting standards such as AAF 01/06, are best suited to measuring objective criteria. They customarily focus on processes and

compliance procedures, rather than establishing whether the practices applied achieve the desired outcomes. It is difficult to see how assurance reports can be applied to engagement and voting practices which, by their nature, are much more subjective. Effective dialogue between investors and issuers cannot be judged using a compliance checklist. The methods used depend upon the particular circumstances of the company, the investors, the issue being considered and many other factors. Every communication will be different and difficult to measure or quantify.

The Stewardship Code needs to retain and promote flexibility, and not seek to reduce engagement practices to a box-ticking exercise. Introducing assurance reports will be detrimental to the effectiveness and standing of the Code. Therefore, the AIC **recommends** that the Stewardship Code should not be subject to assurance reports provided by independent auditors and that reference to this process should be deleted from the Stewardship Code.

### Monitoring

The market should play the primary role in determining the extent to which the Stewardship Code is adopted and implemented. For example, where 'clients' of investors, such as boards of investment companies or pension fund trustees, value engagement, they will pro-actively seek to ensure that the managers they employ review their own arrangements and apply best practice. Other stakeholders, including trade unions and the media, will also review practice and publicise their concerns where relevant.

It is clear the Combined Code, which also adopts the approach that the market should determine the extent to which it is adopted, has led to real changes in governance practices in the last few years. For example, it is now willingly accepted that the role of chairman and chief executive should be separated. Following the banking crisis, there were concerns that scrutiny of some aspects of governance arrangements were not robust enough to prevent company failures. In future, concerns about the level of engagement can be addressed by scrutiny of the take up of the Stewardship Code. Therefore, assuming that the content of the Stewardship Code is appropriate, and that the reporting mechanisms operate as described above, the Stewardship Code should help to resolve any deficiencies in the effectiveness of the Combined Code.

The surveys carried out by the IMA on its members' engagement arrangements are excellent tools for gauging current practice. The AIC anticipates that these surveys will encapsulate the application of the Stewardship Code going forward. We **recommend** that the IMA continues with this invaluable exercise to inform the FRC and the market on practice in relation to the Stewardship Code.

### Review process

The AIC **agrees** that the FRC should adopt the same review process for the Stewardship Code as that already in place for the Combined Code i.e. that the

Stewardship Code should be reviewed, including public consultation, every two or three years in the normal course of events.

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