

Response from BlackRock on the Financial Reporting Council's Consultation on a Stewardship Code for Institutional Investors

As a major, long-term investor in British companies, BlackRock takes a keen interest in and actively promotes corporate governance best practice as set out in the Combined Code. Accordingly, we support the proposal to establish a market-wide, principles-based code setting out the responsibilities of institutional investors in relation to the companies in which they invest. We implemented the earlier codes published by the Institutional Shareholders' Committee and were involved, through our trade bodies, in the drafting of the most recent version. However, in our view, the lack of a single owner of the process and the resulting Code has produced something more complex than necessary. Given the importance of the Code to UK practice, and its complementary relationship with the Combined Code, we welcome the involvement of the FRC. We would encourage the FRC to take its time in developing a Code of high quality which assists practitioners in enhancing their stewardship activities.

Objectives of the Stewardship Code

BlackRock agrees with the objectives proposed by the FRC against which to judge a Stewardship Code. Setting high standards and encouraging practitioner ownership of them is central to the success of a voluntary approach to best practice. We welcome also the emphasis on ensuring that engagement is closely linked to the investment process within investment firms. In BlackRock's view, not only should governance-related engagement be integrated with investment decisions (including decisions to remain invested) it should focus on those matters that clearly have the potential to affect materially the economic interests of shareholders. We agree also with the aim to improve communication with companies in which shareholders invest. This helps clarify that meaningful engagement requires an ownership stake.

We endorse strongly a 'comply or explain' approach to the implementation of such a Code. A market-led solution whereby greater transparency encourages continual improvement in practice is in our view preferable to a mandated approach that has compliance as its goal. It might be helpful to be more explicit in the Code that those who explain their reasons for not complying have met the standard. If they can provide explanations for not engaging that are convincing to their current and prospective clients then that should be sufficient. If clients are not convinced they can exert their influence to bring about change.

Clearly, the clients of asset managers and the beneficiaries of asset owners have an important role to play in ensuring their agents fulfil their expectations. This will require them to be clear about what their expectations are, how the performance of their agents will be assessed and over what time frame. Rather than referring to 'institutional investors', we suggest that there ought to be a clearer distinction between, and more detailed discussion of, the different ways in which asset owners and asset managers discharge their responsibilities under the Stewardship Code.

Role of the FRC

BlackRock considers the FRC to be an appropriate 'owner' of a Stewardship Code given its track record as a thoughtful and pragmatic owner of the UK Corporate Governance Code. This gives us confidence that a Stewardship Code operated and monitored by the FRC would evolve to reflect the experiences of practitioners and general market developments. That said, we believe the FRC ought to set out in detail what it believes its oversight responsibilities entail as this is not clear in the current draft.

We believe that the proposed Stewardship Code needs considerable redrafting. If an immediate redrafting is not possible, we would strongly encourage the FRC to review the Code within a year of its adoption with this in mind. In our view, the FRC ought to start afresh, drawing from the ISC Code, with the aim of drafting a Stewardship Code that speaks in one voice, is more clearly aligned with the Combined Code and which provides clearer guidance to users, particularly those not already active in corporate governance engagement in the UK. In particular, definitions of the core concepts and amplification of the requirements would be helpful.

Engagement is a core concept that clearly needs to be defined in the Code as, in our experience, investors have a wide range of views as to what it involves. In light of that, it would be helpful if the Code provided a definition and required investors to provide their own definition in their reporting, which would provide the context within which to assess the engagement activities covered. From BlackRock's perspective, engagement is a range of activities covering a spectrum of intensity. Voting and discussions with companies around routine voting issues are clearly low intensity. At the more intensive end of the spectrum is the type of engagement that involves numerous meetings over an extended period of time, often focussing on strategic or board leadership issues. We do not believe that engagement must necessarily have change as its objective, although sometimes this will be the desired outcome. Consistent with the Combined Code, we are more concerned with developing a mutual understanding between ourselves and the company on matters relating to shareholder value through constructive, two-way communication.

The implication of the Code, and certainly some of the recent public debate, is that engagement is the solution to any problem in relation to portfolio companies. A more fulsome discussion in the Code of the limitations of engagement might help ensure reasonable expectations of it and of those responsible for implementing it. In our experience, these include:

- Shareholders often, rightly, have different views on a situation. Even where there is agreement on what the problem is it can be considerably more difficult to establish a shared view on the solution. Thus, companies which engage with their shareholders will not always get a clear message about what is expected. Boards and management are responsible for directing and managing companies.

The engagements most closely linked to shareholder value (i.e. on strategic and leadership issues) can, or can be perceived to, put shareholders in a position of second-guessing those with legal responsibility to run the company. Ultimately, the board has to distil the various messages and take a decision, the consequences of which may not be clear for a considerable time.

- Many investors are concerned about unintentionally being considered by the company or regulators to have formed a concert party if engaging collectively or discussing views on a company with one another whilst engaging independently. The FSA has issued guidance which provides some clarification in the UK. However, risks still remain and concerns about ascertaining boundaries may deter investors nonetheless. This is a particularly significant concern in some Continental European markets. There are similar concerns about inadvertently receiving, or being perceived to have received, inside information either from the company or other investors.
- Shareholders have limited resource and must allocate it judiciously, generally on based on the size of their holding. Collective engagement can help share the workload but only to a certain extent as each investor needs to retain some control and oversight.
- Engagement takes time and sometimes events over take an engagement. Further, shareholders can be convinced, wrongly as it may turn out, by a company's response to concerns or the degree to which change has been embedded. Sometimes the most responsible action, in terms of protecting the economic interests of clients and beneficiaries, is to divest.

None of these is sufficient to rule out engaging with companies but they ought to be recognised as challenges that can impact the perceived effectiveness of stewardship.

In overseeing the implementation of the Code we believe the FRC should sponsor an industry-wide survey to be undertaken by an independent organisation. We believe this would help ensure the results are credible to parties outside the industry interested in encouraging enhanced engagement. The Investment Management Association has undertaken a survey for a number of years that could usefully be the basis for a survey under the new regime. Equally, there might be lessons to be drawn from the survey carried out by the secretariat of the United Nations Principles for Responsible Investment. The latter provides each respondent with a report benchmarking it with its peers that the investor can choose to make public. We encourage the FRC to establish its survey as the industry standard so that resources that would otherwise be deployed on engagement activities are not diverted to responding to a multitude of surveys from consultants and others.

Coverage

BlackRock does not believe that the Stewardship Code should be applied to the agents of investors, such as consultants and research providers, even in spirit. They do not have responsibilities for stewardship activities although they do support them. We would rather they developed their own codes to cover matters such as conflicts

of interest and advancing responsible investment or ownership. If there is not the appetite for this, the Code could suggest that asset owners and asset managers request that service providers attest annually how they have provided support in fulfilling the responsibilities under the Code.

BlackRock has some experience of cross-border engagement. A general observation is that it is more likely to be effective if you can work with a local investor who shares your concerns so that the domestic investor leads and the foreign investors take on a supporting role. However, it takes time to build the relationships and levels of trust necessary to facilitate collective engagement of this type. The limitations of engagement noted above are exaggerated when operating offshore. In a number of markets it is not necessarily accepted that shareholders have a role, let alone a responsibility, to engage with boards and management and identifying like minded investors is not always straight forward. In addition, there are the obvious language and cultural barriers. For these reasons we support the apparent intention that a Stewardship Code would apply primarily to UK investors in UK public companies. That said, we believe the Code ought to be clearer about the extent to which its requirements extend to non-UK companies to ensure a common understanding and expectations. Given that other markets may well develop similar codes in time, the Code could usefully propose the establishment of a 'passporting' mechanism.

Content of Code

As already noted, we believe that the proposed Code ought to be drafted afresh. We would prefer a tone similar to that in the Combined Code which emphasises building relationships and understanding between the various players involved in a successful governance framework. This would seem more consistent with the 'comply or explain' approach underpinning the Combined Code which presumes that shareholders will be willing to engage and to give due consideration to the explanations given.

We would prefer principle four to require an explanation of a shareholder's engagement approach, including escalation. In our experience, where change is the desired outcome, perseverance and building trust and respect are more important to successful engagement than, for instance, threatening to call EGMs. In addition, engagement is a dynamic and iterative process whereas the list provided suggests that there is a natural progression.

We would suggest including a principle covering engagement with those who influence the corporate governance framework including the FRC and other regulators, as well as government bodies. In our view, it is important for asset managers and asset owners to contribute to the public policy debate and to build a better understanding of our activities amongst those in the wider community.

Disclosure and reporting

In our view, the disclosure relating to adoption and implementation of the Code should be directed to clients, and should be made on the investor's website and to clients directly on an annual basis. We would expect that the disclosure would include a general statement on the organisation's philosophy in relation to stewardship, amplified by an explanation of how each principle was met or why it was not met. We agree also with the suggestion made by some practitioners that a senior member of the investment or engagement team be named as the contact person for companies wishing to engage.

We do not think it necessary for the ISC to keep a list of those who have adopted the Code but would not be opposed to it doing so. It is not obvious however that the ISC website would be the first port of call for a client or company interested in understanding a shareholder's engagement approach. In our view, clients or beneficiaries, who have a vested interest in ensuring an appropriate engagement strategy is implemented by shareholders, are best placed to monitor their performance.

Similarly, we believe that reporting on engagement should be directed to clients rather than the general public. Our fiduciary responsibility as it relates to engagement is to our clients and they have the interest to hold us to account. BlackRock agrees with the point made in the Code that there are advantages to agents and principals determining between them the format and content of reporting.

As noted above, BlackRock considers a range of activity to be engagement, from telephone calls around voting issues, written correspondence and face-to-face meetings. A condensed explanation of the lower intensity engagement activity is sufficient, in our experience, supplemented by case studies explaining the purpose of the engagement, the actions taken, and the outcomes of the more intensive engagements. A discussion on how the success or otherwise of an engagement would be evaluated can also be helpful. Case studies should make clear the degree of involvement of senior personnel and the extent to which an engagement was linked to the economic interests of shareholders. It is also interesting to discuss at a high level engagements that were not deemed successful, the reasons why and the lessons learned. Such discussion helps manage expectations and ensures that clients, and others, appreciate that engagement is a dynamic process and evolving practice. It could also potentially inform changes to the Stewardship Code and to practice more generally.

In relation to voting, BlackRock believes that reporting on an exceptions basis (i.e. votes withheld or cast against management, votes cast for when the stated policy would suggest a vote against, and shareholder resolutions) gives a better sense of the approach taken than resolution by resolution reporting. In addition, it is helpful to provide a discursive report of notable AGMs and voting issues.

BlackRock expects that there will be pressure to count and compare stewardship activity. There is a balance to strike and caution must be exercised to ensure that quality is not compromised for quantity. Statistical reporting on engagement (and even on voting) can, in our experience, encourage a simplistic interpretation. For example, some commentators interpret high levels of opposition to management as an investor being more active and 'responsible'. In fact, it can take more effort to get to a position of being able to support management through engagement that leads to a better understanding of a company's approach or to a commitment to change. We are also concerned that the focus on statistics, and the likely benchmarking of investors on that basis, will lead to more engagement of low intensity and effectiveness but high volume such as 'round robin' letter writing. We would encourage the FRC to emphasise throughout the Stewardship Code the need for stewardship activities to prioritise value enhancement and outcomes rather than activity.

Similarly, on reporting of engagement we believe there is a balance to strike between transparency and confidentiality and that more could be said on this in the Code. It can be detrimental to publicise the most sensitive engagements, even once completed, as people's careers and professional reputations are often involved. Too onerous a reporting requirement could result in the counterproductive outcome that those who are not signatories to the Stewardship Code are better able to engage because companies are more willing to be open with them, knowing that even the fact of the engagement will be kept private. As a long term investor, BlackRock will be engaging with the same companies and many of the same people over time so it is important that we are trusted to be discreet. We recognise the need for some level of public reporting but believe that the most important focus is our clients, the beneficiaries of these activities, and providing them with sufficient information in confidence to enable them to assess the degree to which we are meeting their expectations.

BlackRock is comfortable with the proposal to recommend that implementation of the principles of the Stewardship Code be verified by an independent auditor. That said, we note that several of the principles as drafted are too subjective for audit. The focus would necessarily be on the more procedural aspects of implementation. We are also slightly concerned about the risk of auditing distracting practitioners with the minutiae, such as investigating immaterial differences between votes cast and reported, rather than their focussing on the activities that have an economic impact for clients. We agree that the fact of the audit, rather than the detail of the outcome, should be disclosed. We believe that the Code should make clear that not conducting an audit should not be seen as a breach of the Code, particularly for non-UK supporters.

We hope these comments are helpful in your deliberations.

BlackRock
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