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Dear Ms Haan

Consultation on the proposed Stewardship Code

INTRODUCTION

1. Ernst & Young LLP welcomes the opportunity to comment on *Consultation on a Stewardship Code for Institutional Investors 2010* ("the Consultation"), issued by the Financial Reporting Council ("FRC").
2. We were mindful, when responding to this Consultation, that measures are already in place to help ensure the responsibilities and rights of share ownership are understood and exercised respectively. In particular, board directors have a legal obligation to act in the interest of their shareholders, by promoting the long-term success of the company¹. Conversely, shareholders have the means granted to them by law (e.g., voting and other rights) to help make sure this happens and that directors fulfill these obligations².
3. However, in light of the recent economic crisis and subsequent focus on matters associated with corporate governance, it is understandable that the regulatory community should want to review shareholder engagement and see whether improvements can be made. We are happy to offer our opinions on this, but we do so with an open mind. We make no assumptions that the level of shareholder engagement in the UK is somehow broken, and that fixing it will improve corporate governance and prevent another financial crisis from happening.

¹ S 172, Companies Act 2006.

² Institutional Shareholder Committee ("ISC"), formed in 1991, provided guiding principles on share ownership, the forerunner to the Code on the Responsibilities of Share Ownership.



OVERALL OBSERVATIONS

4. In our view the *Code on the Responsibilities of Share Ownership*, ("the Code") produced by the Institutional Shareholder Committee ("ISC"), provides a clear outline of best practice. Renaming the Code and placing it under the auspices of the FRC should help to encourage greater interest in its principles. In this regard we believe the Code's "comply or explain" principle is particularly important and worthy of promotion. This is because it acknowledges the difficulty some institutions will face when seeking to engage (with investee companies), providing them with an opportunity to choose whether, or to what extent, they should engage relative to their business needs in general, and client requirements in particular.
5. Of course some categories of investor (e.g., pension fund managers) will have less choice, because they are already required by law to disclose their engagement activities to their clients (the beneficial owners). In this example the investor discloses its engagement plans and activities in its Statement of Investment Principles³.
6. With the exception of pension fund managers, for reasons just explained, we can see the possibility of investors wishing to offer their clients some degree of assurance that they are taking their stewardship responsibilities seriously. This could be helpful to the clients, if only in terms of informing their decisions on which investors to use, and when to switch them over.
7. However, we expect that most clients will be focused on the overall performance of the funds under management. Some may be interested in a fund's underlying aggregation of companies. But few will be bothered about the duration of individual shareholdings and/or the extent to which the investing institution has, or intends, to *engage* with each of these companies individually. We believe this situation becomes more apparent where the performance of funds meet or exceed client expectations.
8. Therefore the *output* and *outcome* of any stewardship code, in terms of *engagement* with investee companies and *influence* over corporate governance respectively, will depend on the client/investor relationship. This situation is unlikely to change, regardless of a code's provenance and the determination of its sponsor.
9. Similarly, the potential number of investors willing and able to follow the Code to its full extent (with clients willing to pay higher fees to cover the cost of compliance), is likely to be limited to those institutions and beneficial-owning clients based in the UK. Given that many entities are now incorporated outside the UK⁴ (with clients based overseas as well), the ambit of the code may be limited.

³ S 244 Pensions Act 2004. Disclosures can be made via the Statement of Investment Principles or in the annual report.

⁴ The Office of National Statistics published the results of a share ownership survey in 2008. It showed that overseas share holdings in the UK stock market increased to 41.5 %, but the proportion of these shares held by pension funds and insurance companies fell to 26.2 %.

10. None of these comments are meant as criticisms of the proposed Code. They simply reflect observations of unalterable circumstance, namely: commercial agreements between institutional investors and their clients; the drive towards shorter-term shareholdings; changes in investor demographics brought about by the global economy; and difficulty in evaluating the output and outcome of this or any other code.

RESPONSES TO QUESTIONS

- Q1. What are the responsibilities for engagement of institutional shareholders to the beneficial owners whose interests they represent? Does the ISC Code cover all the relevant responsibilities?**

The responsibilities for engagement, in the way described, are many and varied. This ranges from agreements on where the beneficial owners' funds will be invested (e.g., companies and sectors) to how the corresponding voting rights will be exercised (e.g., use of proxy voting agents). The Code covers these responsibilities at a high level, which is appropriate for a principles-based code, but there may be scope for separate guidance later on.

- Q2. 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?**

Institutional investors are expected to take an interest in their investee companies, as an obligation to their clients (the beneficial owners). This requires a level of engagement which, it could be argued, should extend beyond the exercise of voting rights.

We believe it is mutually beneficial for companies and investors to understand each other's objectives, especially if it is the intention of the investor to hold shares for the longer term. This can, in effect, provide boards with a mandate to expedite decisions and seek funding to gain commercial advantage. The investors can also build their trust and confidence in the boards, reducing the risk of sudden divestments brought about through misunderstanding and/or mistrust.

The Code focuses on a requirement for investors to *engage*. This suggests that they periodically review, monitor and oversee the performance of an investee company. But to do this effectively (in long-term investments) may require investors to be more proactive, by increasing their knowledge and understanding of the company's business strategy, model and key performance metrics. This will necessitate an *ongoing dialogue* with the chairman and other board members. We believe there may be scope to place more emphasis on this in the Code.

Q3. Are the respective responsibilities of the different parts of the investment chain sufficiently clear and appropriate?

The degree of clarity and appropriateness, of the different responsibilities that form the investment chain, will depend on which part of the chain you occupy and to whom you are responsible. As we do not occupy a position in the investment chain, we are not best placed to answer this question.

Q4. Does the Code strike the right balance between the need to avoid over-specification that might discourage the application of the Code and the need for it to be effective with an appropriate degree of transparency?

Any code which is principles-based is, by definition, high-level. In this regard we believe the ISC Code strikes the right balance and avoids over-specification.

As with other codes (e.g., the UK Corporate Governance Code) getting the balance right involves an iterative process of periodic review and refinement. Over time it might be appropriate to add supporting principles and/or separate guidance to the Code, but it is important that developments like this are proportionate and meet a clearly defined need. This can only be done once the Code is launched and its effectiveness is monitored.

To this end it will be necessary to gauge objectively the effectiveness of the Code. This will be a difficult task to accomplish, not least because it will be necessary to measure *outputs* and *outcomes*, and they do not always correlate with each other. For example, we believe it will be possible for an investor to become successful (with satisfied clients), without adhering to the Code. In addition, investee companies will be capable of governing themselves effectively, for reasons other than the engagement of institutional investors.

Q5. Are there any parts of the ISC Code where further guidance is needed, or where the existing guidance should be amended?

For the reasons explained in response to Q4, further guidance should only be provided over time, if or when there is a case for doing so.

CONCLUSION

Overall we believe the Code is fit for purpose, especially its "comply or explain" principle. This will help to accommodate those institutions and clients whose circumstances require the adoption of a more flexible approach towards the Code. The principles, as currently drafted, achieve this and leave the way open for the code to evolve as circumstances change.

Over time we expect there may be calls for new principles and/or supporting provisions, with the possibility of added guidance. This iterative process is, in our opinion, the most effective way for any code to develop successfully. It avoids the risk of second-guessing the practicalities and circumstances which can make a code effective or unworkable.

We are grateful to the FRC for publishing this Consultation and we hope you have found our comments helpful. If you would find it useful, colleagues in our firm are available to discuss further any of the points we have raised.

We wish you every success with the rest of the consultation process and encourage you to publish all non-confidential responses, including this one, shortly after the closing date. We look forward to reading the results.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Robin Heath', written over a large, stylized scribble.

Robin Heath
UK Managing Partner
Regulatory & Public Policy