



***Submission to the Financial Reporting Council's Consultation  
on a Stewardship Code for Institutional Investors***

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## 1. About FairPensions

1. FairPensions is a project of The Fairshare Educational Foundation, a registered charity (no 1117244) established to promote Responsible Investment (*RI*) by UK pension schemes and fund managers, and to ensure that the ultimate beneficiaries are well served by institutional investors and other professional agents in the investment world.
2. In the case of pension funds, *RI* most often entails engagement with investee companies i.e. shareholder activism through dialogue, reinforced by the potential exercise of shareholder powers.
3. FairPensions counts among its members organisations representing the beneficial owners of pension schemes, such as the Occupational Pensioners Alliance, UNITE and Unison, as well as thousands of individual pension fund members.
4. Further information about FairPensions and our approach to *RI* can be found on our website at [www.fairpensions.org.uk](http://www.fairpensions.org.uk).

## 2. Introduction

5. We are pleased to have this opportunity to respond to the Consultation Paper issued by the Financial Reporting Council on a stewardship code for institutional investors of the kind envisaged in the final recommendations of Sir David Walker's *Review of corporate governance in UK banks and other financial industry entities* (November 2009).
6. We very much welcome the agreement of the FRC to accept responsibility for the Stewardship Code. This will confer on the code the degree of recognition and authority that the importance of investor stewardship demands.
7. We believe that for far too long there has been a widespread failure to recognise not only that active share ownership is “*central to the regulatory framework for the governance of listed companies in the UK*”<sup>1</sup> but also that the exercise by institutional investors of stewardship over all their shareholdings is essential to protect the interests both of their end-beneficiaries and of the wider public. This public interest dimension has been recognised by the Walker Review as well as by the FRC and is further considered in section 5.5 below.
8. We hope that the advent of the Stewardship Code under the auspices of the FRC will herald the end of this neglect of stewardship principles by fiduciary long-term investors. In relation to all such investors (and for the reasons discussed further below), we would define “*stewardship*” as:
9. “*the responsibility to take all reasonable steps to ensure (i) that investee companies have business models which can deliver growth in shareholder value over the longer term and which have proper regard to the wider economy and environment and (ii) that such business models are being effectively implemented*”.

## 3. Scope and Structure of this Submission

10. In this submission we wish first to comment on some of the general policy questions that are

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<sup>1</sup> Consultation Paper, page 1, paragraph 1.1

raised in or by the Consultation Paper and (insofar as relevant to the Stewardship Code) by the Walker Review. In the light of those comments we shall then make some more detailed suggestions in relation to the draft Stewardship Code appended to the Consultation Paper. Throughout, we shall have regard to the “Issues for Comment” listed in Appendix A to the Consultation Paper. In the final section of this submission, we shall summarise our key comments on these issues, mainly with reference to the relevant paragraphs of the submission.

11. This submission contains several references to the responses which we made to the three recent consultations which the FRC conducted in relation to the Combined Code – now to be renamed the Corporate Governance Code - and to our response to the consultation on the Walker Review. For ease of reference - and to help avoid undue repetition – we are annexing to this response a copy of all these recent submissions.

#### 4. Executive Summary

##### General Comments on the Stewardship Code

12. The Financial Reporting Council (*FRC*) should assume full control of the development and monitoring of the Stewardship Code; the Institutional Shareholders' Committee (*ISC*) should have no special involvement in the regulation of the code, although the ISC should naturally be consulted whenever appropriate along with all other interested parties.
13. The annual monitoring of engagement under the Stewardship Code should either be undertaken by the FRC itself or be outsourced to a wholly independent body; it would be not be appropriate for a trade body, such as the Investment Management Association, to carry out this survey.
14. Since effective stewardship is in the interests of end-beneficiaries and for their benefit, the FRC should seek to find ways for end-beneficiaries to be represented in the Stewardship Committee or other arm of the FRC that will regulate the Stewardship Code. In addition, the FRC should establish a standing committee comprising a cross-section of end-beneficiary and appropriate civil society representatives to advise and comment on the development and operation of the code: an “*Ultimate Owners' Council*”.
15. Equity holdings of long-term investors have become increasingly globally diversified in recent years. Consequently, securing the full potential value for beneficiaries of stewardship principles requires their application to holdings in overseas companies as well as to those in UK listed companies. We therefore consider it essential that the Stewardship Code should apply to all equities of a given investor.
16. Stewardship principles should be observed not only by institutional investors but by other agents and market participants whose activities have a bearing on corporate governance. These include investment consultants and proxy voting agencies. Such parties should subscribe to the Stewardship Code where appropriate. Where this is not appropriate, the code should provide that institutional investors should expect their agents and advisers to demonstrate commitment to stewardship principles.
17. With the advent of the Stewardship Code we suggest that steps should be taken to prevent potentially confusing overlap with the Myners Principles and that those functions of the Investment Governance Group which are within the scope of the Stewardship Code should be transferred to the FRC.
18. In the wake of the financial crisis there should now be an explicit recognition of the public interest in relation to the functioning of the investment markets. The main way in which the Stewardship Code can promote the public interest is by encouraging long-term investors to ensure that investee companies are acting in accordance with the “*stakeholder*” requirements of the Companies Act 2006 and with the Corporate Governance Code, which also refers to these statutory obligations. Similar stakeholder principles should be applied to foreign companies which are not subject to the Companies Act.
19. The interests of end-beneficiaries will usually coincide with the public interest. Accordingly, the Stewardship Code should encourage institutional investors to adopt an enlightened view of their fiduciary duties, including in relation to collaborative engagement.

20. Active measures should be taken to encourage long-term investors to participate in the Stewardship Code. These could include: explicit guidance from the FRC that it is best practice to participate; similar guidance or requirements from the Pensions Regulator to scheme trustees and from the FSA to fund management companies and insurance companies; publication by the FRC, as annexes to the Stewardship Code, of practical guidance notes and/or specimen wording for stewardship activities, especially for smaller investors with limited resources; and stewardship awards from the FRC based on the annual monitoring of the Stewardship Code.
21. If, despite such measures, progress in the number of participants or the quality of participation in the Stewardship Code falls short of the FRC's expectations, then in due course consideration should be given to the introduction of an annual "*Stewardship Levy*" on all institutional investors. The FRC could use money raised by the Stewardship Levy on a discretionary basis to help signatories to the Stewardship Code with specific aspects of engagement, such as collaborative engagement or the resource problems of smaller occupational pension schemes.

#### *Specific Comments on the Wording of the Draft Stewardship Code*

Our main comments (grouped under the headings in the draft code) are as follows:

##### *Introduction & Scope*

22. There should be an unambiguous statement that it is best practice for long-term investors to commit to the Stewardship Code.
23. It is no longer acceptable to say that institutional investors have no duty to the wider public. This should be replaced by "*stakeholder*" wording.

##### *Principle 1 (disclosure of policy on discharge of stewardship responsibilities)*

24. "*Stewardship*" should be defined. The definition we suggest is: "*the responsibility to take all reasonable steps to ensure (i) that investee companies have business models which can deliver growth in shareholder value over the longer term and which have proper regard to the wider economy and environment and (ii) that such business models are being effectively implemented*".
25. In recognition of international best practice and because environmental and social factors increasingly have financial implications, there should be a specific recommendation to disclose the integration of social and environmental, as well as governance, considerations into the investment process.

##### *Principle 2 (conflicts of interest)*

26. This Principle should be strengthened in the ways suggested. These include: compliance audits; guidelines from the FRC on the content of conflict policies; remuneration structures geared to long-termism and qualitative benchmarks e.g. on engagement policies; a related default mandate published by the FRC as an annexe to the Stewardship Code; discouragement of excessive closeness to corporate management; and face-to-face reporting to end-beneficiaries on at least an annual basis.

27. The Stewardship Code should cover not only the management of conflicts directly affecting the institutional investor but also the need for investors to use their influence to address structural conflicts elsewhere in the investment chain which damage long-term shareholder value, including perverse or excessive incentives for company boards and advisers in relation to mergers and acquisitions.

Principle 3 (monitoring investee companies)

28. This Principle should emphasize the role of the Stewardship Code in helping to enforce the Corporate Governance Code.

Principle 4 (intervening in investee companies to protect shareholder value)

29. This Principle should be made more specific as to the circumstances in which intervention may be called for e.g. the company's acquisition/disposal strategy or inappropriate remuneration or severance packages.
30. There should be fuller wording to cover concerns over an investee company's policy on corporate social responsibility. For example, we think that the Principle ought to state that grounds for intervention should include concerns about “*the company's approach to corporate social responsibility, including its approach to the potential opportunities and risks arising from social and environmental matters*”.

Principle 5 (collective action by investors)

31. This Principle should give fiduciary investors the guidance suggested to encourage them to participate in collaborative actions that could yield collective benefits.
32. Fund managers with multiple clients should be required to give effect to each client's voting policy. They should also take all reasonable steps to avoid or manage conflicts between their clients' wider engagement policies.

Principle 6 (policy on voting and voting disclosure) & Principle 7 (reporting on stewardship and voting)

33. The Stewardship Code should operate to encourage a more considered use by institutional investors of their voting rights. As part of this, the FRC should publish a model voting disclosure template as an annexe to the Stewardship Code. This would be designed to facilitate accountability to beneficiaries, comparative analysis of fund managers' voting records, and the FRC's annual monitoring of the Stewardship Code.
34. The ISC voting disclosure framework published in 2007 as an adjunct to the ISC Statement of Principles should now be subsumed into the Stewardship Code. In any event, some of the provisions of the framework should be changed, as being insufficiently transparent.

## 5. Comments on General Issues

### 5.1. The limitations of a “comply or explain” code

35. In previous submissions we explained why we did not think that a voluntary “*comply or explain*” system would be enough to bring about the far-reaching changes in governance which we believe are possible and necessary to protect the long-term financial interests of pension fund members and to serve the public interest.<sup>2</sup>
36. Nevertheless, we see the acceptance by the FRC of oversight of the Stewardship Code as a significant and welcome development which offers the best chance for success of a voluntary code. The corollary is, however, that if the Stewardship Code does not bring about the required changes in behaviour, then the case for a mandatory regime will be even more compelling. We therefore believe that if the FRC concludes from its ongoing monitoring of the Stewardship Code that insufficient progress is being made, it should be prepared to identify those areas where there appears to be a need for further regulation and to make recommendations accordingly.
37. In this context, we think that it is particularly important that as part of the monitoring process, the FRC should seek to measure progress – or lack of it – against some quite specific benchmarks (for example in relation to willingness on the part of fund managers to vote against corporate management in cases where there is a clear breach of the Corporate Governance Code). This should be combined with more qualitative assessment of engagement practices (for example, in relation to instances of productive collaborative engagement). In both cases, we suggest that the FRC treat the biennial reviews of the Stewardship Code as the “*milestones*” by which to measure progress against a pre-announced timetable for progress.

### 5.2. The regulatory structure for the Stewardship Code

38. As we have previously indicated, we strongly support the creation of a separate code dedicated to institutional investors, as against the alternative of merely expanding the section of the old Combined Code relating to shareholders. We did, however, make clear in our Walker Review submission that our support was dependent on the proposed Principles of Stewardship not being subject to a softer regime than the Corporate Governance Code and that, in particular, there was a full “comply or explain” system.<sup>3</sup> We therefore think it essential that the “comply or explain” regime for the Stewardship Code apply to all institutional investors which sign up to the code and that it should take the form described in the second option outlined in paragraph 5.9 of the Consultation Paper i.e. “A statement of how the firm has applied the principles within the Code, in a manner that would enable clients to evaluate how the principles have been applied, with an explanation of non-compliance against each of the principles where applicable”.

We would add that, moreover, the reference in the above wording to “clients” should be read as extending to “clients **and beneficiaries**”.

In this context, we support the ISC recommendation, referred to in paragraph 5.12 of the Consultation Paper, that investors who sign up to the code should obtain an independent

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<sup>2</sup> See e.g. our first FRC submission, page 12, and our Walker Review submission, pages 9 & 10.

<sup>3</sup> See our Walker Review submission, page 18.

opinion from an auditor on their engagement and voting processes and that the existence of such assurance reports should be publicly disclosed. We would, however, further suggest that the contents of the assurance reports should be made public, as part of the overall monitoring of compliance with the code.

### 5.2.1. An independent regulator

39. Although the current draft of the Stewardship Code is the same as *The Code on the Responsibilities of Institutional Investors* issued by the ISC in November 2009, we believe it is essential that the FRC assume sole responsibility for the Stewardship Code and that the ISC have no ongoing formal role (although naturally it should be consulted whenever appropriate, along with all other interested parties). As we said in our Walker Review submission, we consider that the ISC, as a trade body, has conflicts of interest which should disqualify it from playing any part in the regulatory function.<sup>4</sup>
40. Moreover, as we said in our third FRC submission, it is important that the Stewardship Code and the Corporate Governance Code be mutually consistent and supportive and that they be regularly reviewed together.<sup>5</sup> Only the FRC could co-ordinate this process.
41. We are raising this point again here because we understand that the FRC's present intentions in this regard are still not entirely settled, even though the Consultation Paper confirms, in paragraph 1.9, that the FRC has taken on responsibility for the Stewardship Code, in accordance with Recommendation 17 of the Walker Review
42. In particular, we note that the ISC press release of 16<sup>th</sup> November 2009 relating to the ISC's new code (reproduced in Schedule 8 to the Walker Review) stated that in view of “*the challenge of supporting and implementing the Code*” the ISC was forming a committee “*including representatives from senior investors, the main investment trade associations and corporate governance practitioners*”. The committee would consult on new arrangements for the ISC “*which will ensure that the Code receives firm and proactive backing from senior levels in the investment industry*”. This appears to be the same committee as is referred to in paragraph 2.7 of the Consultation Paper and it is evidently still intended to play some role in relation to the Stewardship Code. Clarification would be helpful.

### 5.2.2 An independent monitor of engagement

43. Recommendation 18B of the Walker Review states:

*“All fund managers that indicate commitment to engagement should participate in a survey to monitor adherence to the Stewardship Code. Arrangements should be put in place under the guidance of the FRC for appropriately independent oversight of this monitoring process which should publish an engagement survey on an annual basis”*

44. We assume from paragraph 5.2 of the consultation paper that the FRC will be making arrangements to implement this recommendation. For the reasons explained in section 5.1 above, we consider it essential that the monitoring process apply to all institutional investors who subscribe to the Stewardship Code, not just to fund managers. We wish to highlight here the stipulation in the Walker Review that the monitoring process be “*appropriately*

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<sup>4</sup> See our Walker Review submission, pages 18 & 19.

<sup>5</sup> See our third FRC submission, pages 1 & 2.

*independent*". In this context, the Review suggested that the current Investment Management Association (IMA) survey of engagement practices among the 32 largest fund managers in its membership "may serve as the most practicable starting point but with the recognition that governance changes will be required to provide for the necessary independence from the industry".<sup>6</sup>

45. We think, however, that it would be unacceptable in principle for the IMA, as the trade body for the asset management industry, to be assessing its own members for the purposes of the Stewardship Code.

46. This objection in principle is reinforced by the terms of the IMA's submission to the Walker Review, which is on the FRC website. The submission disagreed with the idea of "*public disclosure of managers' commitment to engagement with the intention of changing behaviour*" and was sceptical of the view expressed in the initial report of the Walker Review that long-term returns for all beneficiaries would likely be improved "*by some form of governance, engagement or stewardship activity*".<sup>7</sup>

47. The IMA submission also commented on Recommendation 22 of the initial Walker Review (unchanged in the final version), which reads:

*"Voting powers should be exercised, fund managers and other institutional investors should disclose their voting record, and their policies in respect of voting should be described in statements on their websites or in another publicly accessible form."*

48. The IMA stated that "*we are strongly against this recommendation and disclosure being made mandatory or that it should be to the public*"<sup>8</sup>

49. We are not immediately concerned here with the merits of the IMA's views (although it will come as no surprise that we disagree with them): the point which we are making is that it would be inappropriate (not to say incongruous) for a body which is so out of sympathy with important aspects of the Stewardship Code to be charged with its monitoring

50. Accordingly, we suggest that the FRC carry out the survey itself. Alternatively, the survey should be outsourced to a suitable academic organisation or other body which is free of conflicts of interest and which can credibly be seen as fully supportive of the Stewardship Code.

### 5.2.3 Representation of end-beneficiaries

51. To ensure that responsibilities towards beneficiaries are met, we believe, as stated in our Walker Review submission, that the committee or other body within the FRC that will be responsible for the development and operation of the Stewardship Code should include representatives of the ultimate owners of the assets under management, such as pension scheme beneficiaries and life assurance policyholders. We also urged in that submission that thought be given to how to secure such representation.<sup>9</sup>

52. In order to advance such thinking, we would suggest that the following bodies or interest

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<sup>6</sup> Walker Review, page 83, paragraph 5.39.

<sup>7</sup> IMA letter to Sir David Walker of 7 October 2009, page 3

<sup>8</sup> *Ibid*, page 17

<sup>9</sup> See our Walker Review submission, page 18.

groups would be suitable candidates for representation:

- a) consumer organisations which cover financial services (such as Which?, which is already represented on the Investment Governance Group referred to below);
- b) the TUC;
- c) member-nominated pension scheme trustees (*MNTs*), who should be drawn from schemes of differing sizes. The TUC's network of MNTs might be useful here as a means of finding suitable applicants, although all MNTs, whether or not members of the network, should be eligible;
- d) organisations representing pension scheme members, such as the Occupational Pensioners Alliance;<sup>10</sup>
- e) organisations representing private long-term shareholders, including those whose shares are held in the name of nominee companies of institutional investors, such as the UK Shareholders Association;<sup>11</sup> and
- f) individual end-beneficiaries of every kind, including those without any specific representative organisations, such as those with personal pension schemes, insurance policies or unit trust holdings.

53. In the absence of any relevant organised constituency, representatives in category (f) – and possibly in category (c) (MNTs) – might be selected by lot from applicants who met specified qualifying criteria. We think that there would be some merit in using sortition rather than appointment here, both because it would ensure the independence of those selected and because it would likely lead to more people putting themselves forward.

54. We think it important that there should be a significant presence of such end-beneficiary representatives and not merely a token appointee, who might struggle to impinge upon the group-think of “*the usual suspects*” (as the FRC has put it, in a boardroom context).<sup>12</sup>

55. In this connection, the appropriate number of end-beneficiary representatives would clearly depend in part upon the overall size and nature of the relevant supervisory body within the FRC. We understand that no decision has yet been reached as to this. We suggest, however, that in any event the FRC should establish a standing committee of end-beneficiary and civil society representatives of the kind listed above. The committee's remit would include advising and publicly commenting on the development and operation of the Stewardship Code. This would at last allow the voice of the ultimate owners to be heard directly. We would therefore suggest that this body be known as the “*Ultimate Owners Council*” or some similar name.

### 5.3. The Scope of the Stewardship Code

#### 5.3.1. The Stewardship Code and overseas companies

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<sup>10</sup> [www.opalliance.org.uk](http://www.opalliance.org.uk) (The OPA is a supporter of FairPensions, as is shown on our website [www.fairpensions.org.uk](http://www.fairpensions.org.uk))

<sup>11</sup> [www.uksa.org.uk](http://www.uksa.org.uk)

<sup>12</sup> 2009 *Review of the Combined Code: Final Report*, page 17, paragraph 3.20

56. The Consultation Paper makes clear that the Stewardship Code is intended to relate only to holdings in UK listed companies (e.g. paragraphs 1.7 and 1.10). We appreciate that the Stewardship Code is viewed as a complement to the Corporate Governance Code. However, seen from the perspective of institutional investors and their end-beneficiaries, this leaves an unacceptable lacuna, given the proportion of their portfolios invested in overseas companies.
57. Equity holdings of long-term investors have become increasingly globally diversified in recent years. In 2008, UK workplace pension funds had assets of £800 billion. Approximately 21% of these (£169 billion) were invested in UK equities, while approximately 29% (£230 billion) were invested in international equities.<sup>13</sup> Consequently, securing the full potential value of stewardship principles for end-beneficiaries requires their application to holdings in overseas companies as well as to UK listed companies. We therefore believe it is essential that the scope of the Stewardship Code be widened so as to relate to all equities of a given investor.
58. As the Consultation Paper notes, some countries have chosen to apply international standards, as proposed above. For example, the Danish Financial Supervisory Authority requires institutional investors to report against the UN Principles for Responsible Investment (*UNPRI*), which apply to holdings in all jurisdictions. We would add that the US Department of Labor, in its role as regulator under the Employment Retirement Income Security Act (*ERISA*), has for many years given guidance to fiduciaries that the same recommended principles of shareholder activism and proxy voting that apply to holdings in US corporations apply also to shares in foreign corporations.<sup>14</sup> We suggest that it would be particularly anomalous for the UK, as perhaps the most open of the major financial centres, to adhere to a parochial stance in this respect.

### 5.3.2 The Stewardship Code's application to other market participants

59. We think it is important that all market participants whose activities have a bearing on corporate governance should observe stewardship principles. Such participants would include, for instance, investment consultants and proxy voting agencies. Wherever practicable, this should be achieved by their signing up to the Stewardship Code. Where this is not seen as appropriate (for example, where the specific provisions of the code do not sufficiently relate to the particular business of the entity in question), we suggest that the code should provide that institutional investors who are subject to the code should require such other parties to confirm their commitment to the stewardship principles so far as applicable to them. Such commitment might be evidenced by signing up to an analogous code of practice.
60. For example, we think that it is particularly important that investment consultants should support stewardship principles. This could be especially beneficial in view of the important contribution which consultants are well placed to make in the promotion of stewardship principles, not least by virtue of their statutory role in advising pension scheme trustees on preparing and revising their Statements of Investment Principles<sup>15</sup> and by virtue of their ability to influence the selection and monitoring of fund managers. If consultants are not invited to subscribe to the Stewardship Code, we think that the Stewardship Code should propose that institutional investors appoint investment consultants who are signatories to the

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<sup>13</sup> NAPF annual survey 2008

<sup>14</sup> 29 CFR 2509.94-2

<sup>15</sup> Regulation 2 (2) of The Occupational Pension Schemes (Investment) Regulations 2005, SI 2005/3378.

UNPRI, which has a specific membership section for investment consultants.

#### 5.4 The Stewardship Code and the Myners Principles

61. As mentioned in paragraph 2.12 of the Consultation Paper, the current version of the Myners Principles is now overseen by the Investment Governance Group (IGG). Some of the activities of the IGG cover the same ground as the Stewardship Code. We suggest that in order to prevent duplication of effort and potential confusion between the two sets of principles, the remit of the IGG be reviewed and that such of its current functions as are considered to fall also within the scope of the Stewardship Code should be transferred to the FRC. This rationalisation may entail some revision of the existing Myners Principles. We suggest that failure to undertake this rationalisation risks undermining the Stewardship Code through arbitrage of the two codes.

#### 5.5 The public interest dimension

62. The financial crisis and subsequent recession has brought about an important shift in received opinion regarding the wider public interest in the activities of institutional investors. It has become clear that the general public, as well as the clients and beneficiaries of institutional investors, can feel the negative impacts of ‘ownerless corporations’ and *laissez faire* stewardship of companies. Accordingly, we think that it is essential for the Stewardship Code to confirm the existence of a public interest in effective stewardship, and indeed to confirm that long-only institutional investors have a duty to take into account this public interest. Engagement with investee companies should be the principal way to discharge this duty.

63. Thus, in what we see as a key passage, the Walker Review states:

*“As a matter of public interest, a situation in which the influence of major shareholders in their companies is principally executed through market transactions in the stock cannot be regarded as a satisfactory ownership model, not least given the limited liability that shareholders enjoy. The potentially highly influential position of significant holders of stock in listed companies is a major ingredient in the market-based capitalist system which needs to earn and to be accorded social legitimacy. As counterpart to the obligation of the board to the shareholders, this implicit legitimacy can be acquired by at least the larger fund manager through the assumption of a reciprocal obligation involving attentiveness to the performance of investee companies over a long as well as a short-term horizon. On this view, those who have significant rights of ownership and enjoy the very material advantage of limited liability should see these as complemented by a duty of stewardship. This is a view that would be shared by the public, as well as those employees and suppliers who are less well-placed than an institutional shareholder to diversify their exposure to the management and performance risk of a limited liability company.”<sup>16</sup>*

64. Consistently with this view, the Consultation Paper states (as already mentioned)::

*“The concept of active share ownership is central to the regulatory framework for the governance of listed companies in the UK”<sup>17</sup>*

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<sup>16</sup> Walker Review, page 70, paragraph 5.7

<sup>17</sup> Consultation Paper, page 1, paragraph 1.1

and

*“The FRC believes that the Stewardship Code can contribute to a significant improvement in the stewardship of UK listed companies.*

*The potential benefits are large. More effective engagement should improve the governance and performance of investee companies, assist the efficient operation of capital markets and increase confidence in business. Greater clarity in the respective responsibilities of asset managers and asset owners and strengthened accountability of institutional shareholders to their clients will also strengthen trust in the financial system. A clear understanding of these responsibilities will also assist beneficial owners in setting the terms of their fund mandates and in holding asset managers accountable”<sup>18</sup>.*

65. A key element in this public interest dimension is the “*enlightened shareholder value*” concept of directors' duties introduced in section 172 of the Companies Act 2006, which is referred to in paragraph 1.1 of the Consultation Paper. The draft Corporate Governance Code refers to the board's statutory duties under sections 170 to 179 of the Companies Act, although, as we said in our third FRC submission, we think that the Stewardship Code should set out the specific “*stakeholder*” interests referred to in section 172.<sup>19</sup> As we also said in that submission, this stakeholder approach is even more relevant to long-term institutional investors, because typically they are “*universal owners*” with holdings across the investment spectrum and because their end-beneficiaries will generally share in the stakeholder interests to which their investee companies must have regard.<sup>20</sup>
66. Just as the stakeholder provisions of the Companies Act give guidance as to how directors should fulfil their duties to the company and its members, we think that the Stewardship Code should give similar guidance to long-term institutional investors in relation to the discharge of their own fiduciary duties to their end-beneficiaries. Such guidance should in particular encourage engagement aimed at ensuring that investee companies are paying due regard to stakeholder interests. This is essential if the Stewardship Code is to deliver the hoped-for benefits referred to in the Consultation Paper.
67. As we have already indicated, we do not believe that guidance of the kind suggested should be seen as conflicting with investors' fiduciary obligations; on the contrary, we think that it is now widely recognised that failure to take such stakeholder factors into account could be a breach of fiduciary duty.<sup>21</sup>
68. None the less, some fiduciary investors may apprehend that their duties to their own beneficiaries may not allow them to pursue a particular course of action that would be of public benefit. For example, there is the “*free-rider*” question: collaborative engagement may be collectively the most cost-effective way to deal with a particular governance problem but investors who do not participate in the engagement will still reap the benefit if it is successful. At the same time, their non-participation will make such success less likely, to

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<sup>18</sup> *ibid*, page 4, paragraphs 1.10 & 1.11.

<sup>19</sup> Our third FRC submission, pages 4 & 5

<sup>20</sup> *ibid*, pages 1 & 2

<sup>21</sup> See, for example, the views expressed by Freshfields Bruckhaus Deringer in their report for the United Nations Environment Programme Finance Initiative “*A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment*”, 2005. See also the report “*Fiduciary responsibility: legal and practical aspects of integrating environmental, social and governance issues into institutional investment*”, 2009, also for the UNEPFI.

the detriment of all.

69. It is to be hoped that any such potential problems will prove academic, especially if a sufficient mass of institutional shareholders commit to and abide by the Stewardship Code. If, however, there should turn out to be significant conflicts, whether real or perceived, between some interpretations of fiduciary duty and the public interest, we think such questions should be confronted and, if necessary, resolved by legislation which would clearly authorise fiduciaries to act in the public interest in such cases.
70. We are conscious that general references to “*fiduciary investors*” cover a variety of entities whose obligations to the ultimate owners may take different legal forms: for example, pension scheme trustees, delegated fund managers and insurance companies. None the less, as we indicated in our Walker submission, we think that for the purposes of both the Stewardship Code and the Corporate Governance Code, all market participants in and around the investment chain should be subject to a common, and exacting, standard of fiduciary duty, especially in relation to conflicts of interest.<sup>22</sup>

#### 5.6 Incentives to participate in the Stewardship Code

71. One of the challenges facing a voluntary Stewardship Code is the apparent lack of incentives for institutional investors to sign up to it. We suspect that this is an inherent problem to which there is no complete solution. None the less, we would suggest the following measures as a partial answer:
- a) The FRC should make an explicit best practice guidance that all long-term investors should subscribe to the Code. This should at least provide some degree of reputational pressure to participate. (See further our comments below on this point.)
  - b) The Pensions Regulator should issue guidance to pension scheme trustees to sign up to the Stewardship Code and to expect their fund managers to do so.
  - c) Insofar as this is not covered in the final form of the Stewardship Code itself, the Pensions Regulator should further issue guidance to pension scheme trustees to report fully to their beneficiaries on the engagement and voting activities carried out by agents on behalf of their scheme. For schemes over a certain size, the level of disclosure could perhaps be modelled on the requirements which the FSA are expected to be making of fund managers. Indeed, it may partly be a question of ensuring that the disclosures that fund managers make to the FSA and/or to their clients will also be made - or relayed by the trustees - to the end-beneficiaries. Actual or potential pressure from better-informed beneficiaries should encourage trustees to fulfil their stewardship responsibilities.
  - d) The FSA should also require insurance companies to make similar disclosures to their end-beneficiaries and to the public. Trustees of insured schemes should be required by the Stewardship Code and/or by the Pensions Regulator to take such disclosures into account in the selection and monitoring of their insurers, just as trustees of self-administered schemes should do in relation to their fund manager mandates.
  - e) The FRC could assist institutional investors with practical guidance notes and specimen wording for stewardship-related activities. This should be especially helpful to smaller

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<sup>22</sup> Our Walker submission, page 3

institutional investors, such as many pension funds, who lack in-house resources in this regard. In addition to those items specifically mentioned elsewhere in this submission (e.g. default investment management mandates and voting disclosure templates), we suggest that the FRC could usefully provide a check-list of possible questions for trustees to ask in relation to the selection and oversight of fund managers.

- f) By way of further encouragement, the FRC might consider annual stewardship awards for different categories of institutional investors. These rewards might relate to the findings of the annual monitoring of the Stewardship Code.
72. If, despite such measures, progress in the number of participants or the quality of participation in the Stewardship Code (measured in the ways suggested in section 5.1 above) falls short of the FRC's expectations, then in due course consideration should be given to the introduction of an annual "Stewardship Levy" on all institutional investors, such as has been proposed by some commentators.
73. The FRC could use the funds raised by a Stewardship Levy (i) to equip itself with any extra resources needed in relation to the Stewardship Code, including the conducting or outsourcing of the annual review of the code's operation and (ii) on a discretionary basis to help signatories to the Stewardship Code with specific costly aspects of engagement, such as collaborative engagement or the resource problems of smaller occupational pension schemes. Particular attention might be given to encouraging collaborative engagement and to supporting fund managers pursuing a passive investment strategy, who have less financial incentive to devote resources to engagement.
74. If it is accepted that those investors who do not accept stewardship responsibilities are free-riding on those who do, as stated in the Walker Review,<sup>23</sup> this provides the equitable justification for the Stewardship Levy in principle.

## 6. Specific Comments on the Stewardship Code

75. In this section we shall follow the headings and numberings in the Stewardship Code, as set out in Appendix B to the Consultation Paper. Page numbers referred to are those in the Consultation Paper.
76. We assume that the title of the code will be changed to "*Financial Reporting Council: Stewardship Code for Institutional Investors*"
77. We also assume that all references in the code to the ISC will be replaced by references to the FRC.

### Introduction & Scope

78. Page 25

*Sixth paragraph:* This contains the statement

*"Institutional shareholders are free to choose whether or not to engage but their choice should be a considered one, based on their investment objectives".*

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<sup>23</sup> Walker Review, page 70, paragraph 5.7 (quoted below)

79. In view of the position taken by the Walker Review and by the FRC that engagement by long-term shareholders is in the public interest, we think that this statement should be strengthened by adding:

*“Where those investment objectives are of a long-term nature, it is best practice for the shareholder to choose to engage”.*

80. As is reflected in paragraph 1.7 of the Consultation Paper, recommendation 16 of the Walker Review states:

*“The remit of the FRC should be explicitly extended to cover the development **and encouragement of adherence to principles of best practice in stewardship by institutional investors**” (our emphasis)*

81. We think that there is an important distinction between merely developing best practice for those who choose to engage and establishing a best practice principle that long-term shareholders should engage.

82. In making this suggestion, we are mindful of the passage in the Walker Review that most directly bears on this point and which, for ease of reference, we reproduce below:

*“This Review will propose that fund managers be asked to confirm their commitment to a stewardship obligation or, alternatively, to explain their investment approach in clear terms if they are unwilling to assume such a commitment. Given concerns expressed in the consultative process,<sup>24</sup> it should be emphasised that this Review does not position the stewardship model as uniquely best practice for fund management. All fund managers have the obligation to work within the terms of the mandate agreed with their clients and, even where a fund manager has committed to the stewardship model, this does not preclude a decision to sell a holding in a particular instance where this is judged to be the most effective response to concerns about under-performance. However, the implications of this legitimate business decision should not be avoided. Some governance by owners is essential, at least in respect of the selection, composition and performance of boards, if boards and executives of listed companies are to be appropriately held to account in discharge of their agency role to their principals. Shareholders who do not exercise such governance oversight are effectively free-riding on the governance efforts of those that do.”<sup>25</sup>*

83. We have the following comments:

a) It is true that all fund managers *“have the obligation to work within the mandate agreed with their client”* but where the client is a long-term investor which has a policy of engagement, there is no problem. Conversely, there would be conflict if the fund manager did not carry out the client's engagement policy.

b) As the above passage states, commitment to the stewardship model *“does not preclude a decision to sell a holding in a particular instance where this is judged to be the most effective response to concerns about under-performance”*. The Stewardship Code

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<sup>24</sup> These concerns included those expressed by the IMA in the submission already referred to, which stated: *“We agree that the FRC's remit should be extended to cover the Principles of Stewardship, but it should not mandate adherence to the Principles as a matter of best practice. To do so is to endorse one investment style over another...”* (page 15)

<sup>25</sup> The Walker Review, page 70, paragraph 5.7

explicitly confirms this (page 25, third paragraph). Again, therefore, this is not a relevant consideration. (Indeed, we are not quite sure what point the Walker Review is making here.)

- c) Given the strong language of the Walker Review on “*free-riding*” and on the “*public interest*”, and given the FRC's equally strong affirmation of the public interest case for active share ownership, a failure to give a best practice recommendation on engagement, even in relation to a voluntary “*comply or explain*” regime, might undermine the credibility of the Stewardship Code.

Page 26

84. *First paragraph:* We assume that the intention is that investors that subscribe to the Stewardship Code will now be listed on the FRC website, rather than the ISC website and that their statement on how they implement the Stewardship Code in practice will also appear on the FRC website.

85. *Second paragraph.* This reads:

*“Fulfilling fiduciary obligations to end-beneficiaries in accordance with the spirit of the Code may have implications for institutional investors' resources. These should be sufficient to allow them to fulfil their responsibilities effectively, commensurate with the benefits derived. **The duty of institutional investors is to their end-beneficiaries and/or clients and not to the wider public**”.* (our emphasis)

86. The final sentence closely follows the wording of the *ISC Statement of Principles*.<sup>26</sup> It appears to rule out any considerations of responsibility to the wider public interest. It should be changed, not least in view of the need for the Stewardship Code to reinforce the “*enlightened shareholder value*” philosophy of Section 172 of the Companies Act 2006, referred to paragraph 1.1 of the Consultation Paper and already mentioned above. For the reasons previously stated, long-term institutional investors, as “*universal owners*”, have a particular interest in ensuring that their investee companies are acting in accordance with these stakeholder principles.<sup>27</sup>

87. This express exclusion of a public interest dimension is incompatible with the main thrust of the Walker and FRC reviews, as discussed in section 5.5 above. More broadly, this provision can be seen as an expression of the extreme *laissez-faire* philosophy which prevailed before the financial crisis; we trust that it is common ground that this is no longer an acceptable basis for regulation. We suggest that it be replaced by wording that is consistent with the stakeholder approach of section 172.

88. By way of example, the replacement wording could be in the following terms:

*“Institutional investors should act as fiduciaries for their end-beneficiaries. As fiduciaries, they should seek to ensure that the boards of their investee companies act in accordance with the Corporate Governance Code and with their statutory duties. In particular, as long-term, diversified shareholders with an interest in the sustainability of the wider economy, they should satisfy themselves that boards are paying due regard to the stakeholder interests*

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<sup>26</sup> The ISC Statement of Principles, 2007, section 1 “*Introduction and scope*”, final paragraph

<sup>27</sup> See our third FRC submission, page 5

*specified in Section 172(1) of the Companies Act 2006.”.*

89. With regard to this suggested wording:

- The provision that institutional investors “*should act as*” fiduciaries would cover both those investors who are undoubtedly fiduciaries in the strictest sense (e.g. pension scheme trustees) and those whose fiduciary status may be less clear-cut (e.g. fund managers under a contractual relationship with scheme trustees, or insurance companies managing policyholders' funds). As previously stated, we think that, for the purposes of the Stewardship Code, all institutional investors should accept the obligations of fiduciaries to end-beneficiaries.
- The provision that investors should act “*in accordance with*” the Corporate Governance Code would, in our view, be equally satisfied by compliance with recommendations of the code or by explanation of non-compliance. We think that this should be self-evident, in view of the explicit “*comply or explain*” nature of the code. If it were thought necessary, however, this flexibility could be confirmed expressly.

90. *Third paragraph:* As throughout, we assume that all the references in this paragraph to the ISC will now be to the FRC.

91. In view of the desirability of encouraging Sovereign Wealth Funds (SWFs) to commit to the Stewardship Code, we suggest that there should be a definite statement that the FRC will list such SWFs on its website; “*may*” should therefore be changed to “*will*”.

92. Further to our comments above about the need for the Stewardship Code and the Corporate Governance Code to support each other, we suggest that the last sentence of this paragraph be replaced by wording on the following lines:

*“The FRC will review the Stewardship Code biennially in conjunction with its reviews of the Corporate Governance Code. These reviews will seek to ensure that the two codes continue to complement each other”*

*Principle1: Institutional investors should publicly disclose their policy on how they will discharge their stewardship responsibilities*

93. This Principle raises a question which affects the whole Stewardship Code: there is no definition of “*stewardship responsibilities*” or of “*engagement*”. Without such definitions, there is a danger that the code will be less focussed and less specific. We appreciate, however, that there is a difficulty in that both asset owners and fund managers will often have widely varying views on the scope of their stewardship responsibilities and on the forms of engagement that will best fulfil those responsibilities.

94. For example, the Walker Review does define and describe “*engagement*”, in the following terms:

*“For the purposes of this Review, the term “engagement” relates to initiative (sic) designed to ensure that shareholders derive value from their holdings by dealing effectively with concerns about under-performance. Engagement procedures will include arrangements for monitoring investee companies, for meeting as appropriate with a company's chairman, SID or senior management, a strategy for intervention where judged appropriate and policy on*

*voting and voting disclosure*".<sup>28</sup>

95. Even such succinct and yet comprehensive wording, however, is not necessarily exhaustive. For example, it might be argued that the definition of “*engagement*” is too narrow, as it could suggest that engagement is only reactive to problems, rather than proactive, whereas the Walker Review itself makes clear that this should not be the case.<sup>29</sup>
96. One possible solution to these definition problems which has been suggested would be to specify different degrees of stewardship and/or engagement to which the institutional investor could choose to commit. We can see advantages in this suggestion and would certainly not rule it out. There would, however, likely be disagreements over determining the various categories. A multi-level code of this kind might also be unduly complex and confusing.
97. We are inclined to think that the most practicable way to approach this problem would be to try to identify the core elements of stewardship and engagement that are needed to secure the public interest - which by their nature are more likely to be common to all market participants – and to leave room for individual discretion on other matters.
98. We would emphasise that in this context we do not see “*core*” as being synonymous with “*minimum*” (and still less with “*minimal*”): the public interest requirements could well be quite extensive. To forestall the customary objections about “*prescription*”, we would point out that we are here dealing with a “*comply or explain*” regime, so that if an investment manager, for example, thinks that there are good reasons to depart from the code's recommendations, it can do so and publicly say why. If its way of doing things is then widely thought to be better, this could be reflected in the next review of the code, thereby improving best practice generally.
99. We would suggest that a possible definition of “*stewardship*” would be that already set out in the Introduction to this submission i.e.
- “The responsibility to take all reasonable steps to ensure (i) that investee companies have business models which can deliver growth in shareholder value over the longer term and which have proper regard to the wider economy and environment and (ii) that such business models are being effectively implemented”.*
100. The above wording in relation to delivering shareholder value over the longer term mirrors that in the opening paragraph of the draft Corporate Governance Code. The reference to the wider economy and environment reflects the broader perspective of typical long-only investors and of their end-beneficiaries which, as already mentioned, will normally coincide with the public interest.
101. On this basis, “*engagement*” could be defined as simply the means whereby the stewardship responsibility is discharged. The Stewardship Code could then set out specific forms which engagement could take.

## *Guidance*

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<sup>28</sup> Walker Review, pages 72 & 73, paragraph 5.14

<sup>29</sup> *Ibid*, e.g. on page 79, paragraph 5.30, under the heading “*Communication in normal situations*”

102. Most of the topics listed under this heading are covered under the subsequent Principles, on which we comment below. This leaves the following two items:

103. *“Internal arrangements, including how stewardship is integrated with the wider investment process.”*

We think that the Stewardship Code should specifically require disclosure of the integration of environmental, social and governance considerations into the investment process. FairPensions' own surveys have shown that, despite some improvement, much progress has still to be made in relation to the integration of environmental and social factors<sup>30</sup>. Aside from the relevance of such considerations to the value of the particular investee company, there is a clear public interest in the promotion of corporate social responsibility and in preventing the externalisation by companies of environmental and social costs. Furthermore, this has direct relevance to one of the stakeholder interests specified in section 172 of the Companies act, namely, *“the impact of the company's operations on the community and the environment”*.

104. *“The policy on considering explanations made in relation to the Combined Code”*

Clearly, reference should now be made to the Corporate Governance Code. We suggest, however, that reference be made also to the Stewardship Code itself. We have in mind, for example, that an asset owner such as a pension scheme might need to consider explanations as to non-compliance with the Stewardship Code made by an existing or potential fund manager.

*Principle 2: Institutional investors should have a robust policy on managing conflicts of interest in relation to stewardship and this policy should be publicly disclosed.*

105. We welcome this new Principle: as we have emphasised throughout our previous submissions, we think that the existence of structural and other conflicts of interest in and around the investment chain is one of the most important issues requiring attention. We think, however, that this Principle would benefit from being more specific in the following respects:

- a) There should be an annual independent audit of compliance with the conflict policy and a statement of whether the policy has been complied with. Subject to any genuine constraints of commercial confidentiality, breaches should be disclosed, together with any remedial action taken or proposed.
- b) We suggest that the FRC should publish at least an outline specimen policy on conflicts of interest so as to give some indication of what *“robust”* might mean here. We think that such a policy should deal not only with *“managing”* conflicts of interest but also, given institutional investors' fiduciary status, with avoiding them in the first place. This could have implications for the institutional investor's business model, for example in relation to proprietary trading.

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<sup>30</sup> [http://www.fairpensions.org.uk/sites/default/files/uploaded\\_files/documents/FundManagerRanking08.pdf](http://www.fairpensions.org.uk/sites/default/files/uploaded_files/documents/FundManagerRanking08.pdf) and [http://www.fairpensions.org.uk/sites/default/files/uploaded\\_files/documents/ResponsiblePensions\\_2009.pdf](http://www.fairpensions.org.uk/sites/default/files/uploaded_files/documents/ResponsiblePensions_2009.pdf)

- c) We think that the Stewardship Code should provide guidance on what might be called “*soft*” conflicts of interest. There is a widespread view that one of the reasons for the failings in shareholder oversight in the pre-crisis period was a tendency for investment managers to have too close a relationship with corporate management, with a resulting disinclination to rock the boat.

106. These attitudes might have arisen out of specific considerations, such as the potential concern identified in the Walker Review that a hostile action, such as voting against management at an AGM, could “*reduce the subsequent access to the company of individual institutions that participated in a negative vote*”.<sup>31</sup>

107. There may, however, be more deep-rooted conflicts of interest of the kind described in the Myners Review:

*“the review was told by some that there was a real potential for conflicts of interest. Fund management firms may be keen to attract or keep a contact to manage the pension of the [under-performing ] company in question – or they may be part of a wider financial organisation which wants, for example, the investment banking or insurance business of that company. Similarly, the argument was made that firms may generally not want to be seen publicly (in particular by the press) as troublemakers, in the interests of attracting new business”.*<sup>32</sup>

108. There may also have been more subtle factors in play, including the likelihood that fund managers will have more contact with corporate management than with clients (and especially with end-beneficiaries). This will tend to reinforce a cultural affinity with management, as, for instance, in shared perceptions of what constitutes appropriate levels of pay. Even where there is still a willingness to challenge remuneration packages in investee companies, the institutional investor's credibility will be compromised if its own house is not clearly in order.

109. This gap between institutional shareholders and their end-beneficiaries is part of what might be called “*the double agency problem*”, where the issue of “*the ownerless corporation*” identified by Lord Myners<sup>33</sup> is compounded by that of “*the ownerless owner*”, such as investment managers with a variety of uncoordinated clients, many of which will themselves be fiduciary institutions whose own beneficiaries will typically have little information - and less influence - in relation to the management of their savings.

110. The double agency problem is complex and there is no single remedy. We think, however, that a key part of the solution should be a substantial restructuring of the financial incentives for fund managers, so that these are linked to the protection of shareholder value over the long-term and to other, qualitative benchmarks, for example in relation to engagement activities. We urge the FRC to provide guidance on this in the Stewardship Code.

111. In particular, we suggest that the FRC provide a template for a default fund manager mandate which would cover this issue and which would form an annexe to the Stewardship Code. This could be of especial help to small and medium-sized pension schemes with limited resources to generate or commission their own fund management agreements.

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<sup>31</sup> Walker Review, page 74, paragraph 5.16

<sup>32</sup> Myners Review, page 91, paragraph 5.85

<sup>33</sup> Speech to IMA, 19 May 2009, paragraphs 31 & 32

112. We further suggest that the Stewardship Code recommend that institutional investors, including delegated fund managers, should attend face-to-face meetings with end-beneficiaries where they could render an account of their stewardship. Such meetings should take place at least annually. They might broadly equate to a corporate AGM, albeit in an advisory-only form. In the case of insurance companies, for instance, a meeting to which long-term policyholders would be invited might cover much the same ground in relation to the company's investment performance as a members' AGM in a mutual insurer. In the case of pension schemes, the trustees should convene annual meetings at which both they and their appointed fund managers would report to and answer questions from beneficiaries.

113. As follow-on to the previous point, some of the most egregious conflicts of interest lie in excessive and/or wrongly-structured remuneration incentives within investee companies and among financial market participants, including the investment banks and other professional advisers. These conflicts, therefore, do not relate only to the institutional investors with which this Principle, as presently drafted, is concerned. Yet the institutional investors' end-beneficiaries ultimately bear these unjustified costs, which are in many cases the product of what is effectively a cartel rather than of an open and competitive market. They also suffer from loss of long-term shareholder value when boards or their advisers are swayed by such short-term, perverse incentives, for instance in relation to merger and acquisition activity which, as Lord Myners has pointed out, “so often fails to deliver the outcomes promised”.<sup>34</sup>

114. Consequently, institutional investors should recognise a fiduciary obligation not only to avoid or manage conflicts of interest themselves but also to use their influence to try to correct such abuses throughout the investment chain. The Stewardship Code could address this through specific guidance under existing Principle 3 (monitoring) and / or Principle 4 (escalating activity). In view of the gravity of this endemic problem, however, we suggest that the Stewardship Code include an additional new Principle dedicated to this subject.

*Principle 3: Institutional investors should monitor their investee companies*

115. This Principle is a slightly abbreviated version of the corresponding section in the ISC Statement of Principles (“3. *Monitoring performance*”). As such, it has not been adapted to current post-crisis circumstances, although the fact that even the old wording provided that “*institutional investors should seek to satisfy themselves ....that independent directors provide adequate oversight*” is a reminder that proclaiming principles and applying them are two different things.

116. We therefore suggest that this principle should be redrafted so as to emphasis the central role of shareholder monitoring in ensuring that investee companies are acting in accordance with the Corporate Governance Code.

*Principle 4: Institutional investors should establish clear guidelines on when and how they will escalate their activities as a method of protecting and enhancing shareholder value*

117. Like Principle 3, this Principle is largely derived from the corresponding section in the ISC Statement of Principles (“4. *Intervening when necessary*”). It is, however, less specific. In particular, its predecessor listed nine instances in which investors might want to intervene.

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<sup>34</sup> *Ibid*, paragraphs 28 & 29

Several of these had clear relevance to the contributory causes of the financial crisis, even if they were insufficiently acted upon in practice. These included concerns about:

- “*the company's acquisition/disposal strategy*”;
- “*independent directors failing to hold executive directors properly to account*”;
- “*internal controls failing*”;
- “*inappropriate remuneration levels/incentive packages/severance packages*”; and
- “*the company's approach to corporate social responsibility*”.

118. In contrast, the Stewardship Code Principle contains only a general reference to “*concerns about the company's strategy and performance, its governance or its approach to the risks arising from social and environmental matters*”. In the light of recent events, we would have hoped that the Code would be more specific than the Statement of Principles, rather than less so. We therefore suggest that an updated list of specific triggers for intervention should be reinstated here. We think this would be particularly helpful for pension schemes, giving them in effect a ready-made checklist against which to monitor their fund managers’ performance on stewardship. (Here again, however, the prescience of the previous list underlines the need for a system under which governance principles are not just enunciated but enforced.)

119. We welcome the new express reference to concerns about the investee company's “*approach to the risks arising from social and environmental matters*”. We think, however, that this is too narrow and covers only the negative aspects of such matters; it does not recognise the potential positive contribution to long-term shareholder value from an enlightened corporate social responsibility policy. We suggest that this wording be combined with that of the ISC Statement of Principles so as to refer to concerns about “*The company's approach to corporate social responsibility, including its approach to the potential opportunities and risks arising from social and environmental matters*”.

120. Another intervention trigger specified in the ISC Statement of Principles is “*an unjustifiable failure to comply with the Combined Code*”. As a key purpose of the Stewardship Code is to help enforce the Corporate Governance Code, this point should be reinstated and expanded.

*Principle 5: Institutional investors should be willing to act collectively with other investors where appropriate*

121. As mentioned in section 5.5 above, there is a risk that some institutional shareholders might consider that their fiduciary role inhibited them from expending resources on collaborations to secure objectives that would be for the common good, because they might instead be able to free-ride on the efforts of others.

122. We think that the Stewardship Code should address this point. International comparisons are relevant here. For example, the code should build on the precedent set by the US Department of Labor guidance on ERISA referred to in section 5.3.1 above. The Bulletin provided that in considering whether it makes economic sense to vote, the fiduciary institution must consider not just the plan's weight of votes in isolation but the effect of its own votes together with the votes of others. The Stewardship Code should endorse this principle, not

only in relation to voting but to all forms of engagement.

123. One specific impediment to collective engagement referred to in the Walker Review is the

*“difficulty in ascertaining the beneficial ownership of shares held in nominee accounts or other aggregated forms of holding in order to engage in collaborative engagement”*.<sup>35</sup>

124. This Principle should therefore stipulate that a fund manager with numerous clients should take all possible steps to give effect to the engagement and voting policies of each client. It should also recommend that asset owners take this factor into account in their selection and monitoring of their fund managers and that this question be covered in their mandates.

125. We think that particular attention should be paid to the issue of pooled funds, where the disconnect between the investor and stewardship policies is most marked. This disconnect represents one of the most significant impediments to trustees of small to medium-sized occupational schemes and to group personal pension schemes being able to exercise any effective influence over stewardship. Where funds are held in a pooled arrangement, fund managers should be obliged to follow the voting instructions and policies of all clients. The Companies Act specifically enables shareholders to “split” their vote in this manner and we do not believe that the administration involved would be prohibitive.

126. In the case of engagement activities other than voting, we appreciate that there are real difficulties: it is not possible for a fund manager with multiple clients with different views on a particular issue to represent all such views. As at least a partial solution to this problem, we suggest that, as part of their policy on conflicts of interest, investment managers should consider when accepting mandates whether these contain guidelines on stewardship issues which seem likely to lead to conflicts with the mandates of other clients. They should also take steps to alert clients at an early stage if such a conflict seems likely to arise in relation to a particular matter.

127. For their part, clients should not equate investment in a pooled fund, or even with a segregated mandate, with abdication of their fiduciary stewardship duties. In particular, they should reserve the right to override their fund managers in specific cases of concern.

128. We suggest that in reviewing this Principle - and Principles 6 and 7 - the FRC revisit the 2004 report by Paul Myners to the Shareholder Voting Working Group referred to in paragraph 2.9 of the Consultation Paper<sup>36</sup> and in particular its key recommendations.<sup>37</sup>

129. We would comment that, just as a comparison of the Walker Review's findings on short-termism with those in the 2001 Myners Review induces a strong sense of *deja vu*,<sup>38</sup> so it is depressing that the Walker Review finds it necessary to record problems that were identified in the 2004 report. We think that this is symptomatic of a process of governance reform that is stronger on diagnosis than on treatment. We hope that the Stewardship Code will mark a new departure.

*Principle 6: Institutional investors should have a clear policy on voting and disclosure of voting activity*

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<sup>35</sup> Walker Review, page 74, paragraph 5.16

<sup>36</sup> *Review of the impediments to voting UK shares*, January 2004

<sup>37</sup> *Ibid*, see in particular pages 3 to 7.

<sup>38</sup> See our Walker Review submission, pages 8 & 9

Principle 7: Institutional investors should report periodically on their stewardship and voting activities

130. We are commenting on Principles 6 and 7 together, as we think that it is difficult and undesirable to separate voting policy from the wider engagement policy of which it should form part; the same applies to reporting on the implementation of such policies. Indeed, we suggest that consideration be given to making Principle 6 relate to the statement of policy on stewardship and voting and Principle 7 relate to reporting on both matters. Alternatively, the two Principles could simply be combined.

131. Voting is an essential component of stewardship. Currently, not all institutional investors make effective or active use of this important shareholder right. Whilst it would be preferable for investors to vote all of their shares, what is more important is that careful consideration is given to the allocation of each vote, and that the culture which sees investors reluctant to vote against management is challenged.

132. The ISC press release of 16<sup>th</sup> November 2009 referred to in section 5.2.1 stated, “*Dialogue should be aimed at resolving difficulties. Where, however, dialogue fails to produce an appropriate response, shareholders and/or their agents should be prepared to use the full range of their powers including voting against resolutions and follow-up afterwards. The ISC considers that investors have on occasion been too reluctant to act in this way*”.

133. We think that this November 2009 statement by the ISC is a helpful one and indeed is a better general approach than that reflected in the ISC’s 2007 voluntary voting disclosure framework, referred to in paragraph 2.11 of the Consultation Paper. We would hope to see the Stewardship Code adopt this more robust language.

134. We have already referred to the representations in our earlier submissions that full voting disclosure be made mandatory through the exercise of the reserve powers under Section 1277 of the Companies Act 2006 and that such disclosure should be made public on institutional investors' websites. In the meantime, we believe that the Stewardship Code should recommend this as best practice. This would be in accordance with Recommendation 22 of the Walker Review which we have already quoted in section 5.2.2 above.

135. In their submission to the Walker Review previously referred to, one of the reasons that the IMA gave for their being “*strongly opposed*” to this recommendation was that their own survey showed “*a wide variation in the matters reported, indicating the complexity of this matter and the difficulty of introducing regulations that would require uniform disclosure*”.

<sup>39</sup>

136. We would draw the opposite conclusion. One of the reasons we favour universal disclosure in a common form is that it would facilitate comparative analysis of fund managers' voting records by asset owners, end-beneficiaries and other interested parties; this would be helpful to investors in their selection of fund managers and would thus improve market efficiency. The “*wide variation in the matters reported*” is an impediment to such comparative analysis.

137. We think, therefore, that the FRC should provide a model standard form of disclosure as an

annexe to the Stewardship Code and that the code should recommend its adoption by all institutional investors. This would not prevent investors from supplying any further information in whatever form they thought appropriate.

138. The IMA further objected to the Walker Review recommendation on the grounds of cost: *“For those that do not disclose, there would be costs in disclosure of: setting up systems; vetting the information; and analysing the information”*.<sup>40</sup> Over the long term a standardised, industry-wide system of disclosure should reduce costs, not only for the individual investor but for all relevant parties. For example, it should simplify the FRC's annual monitoring of the operation of the Stewardship Code.

139. We believe that this standard voting disclosure model should be designed so as to achieve the overriding objectives of (i) helping institutional clients and end-beneficiaries to hold their fiduciaries to account (ii) helping clients and prospective clients to compare different institutional investors' performance and (iii) facilitating the FRC's annual monitoring. One starting point might be to take the information supplied in the current IMA survey and to consider how far this covers the required ground. To take just one example, the IMA survey provides information on how institutions voted on key corporate events during the reporting period; this would presumably be relevant to all three objectives.

140. The ISC's voting disclosure framework, referred to above, was designed to be read in conjunction with the ISC Statement of Principles. We understand that no decision has yet been made as to whether the framework is to remain in existence, as a supplement to the Stewardship Code. We suggest that it would better for the framework to be subsumed into the Stewardship Code, so that there is a single document of reference.

141. In any event, we consider the ISC framework to be unsatisfactory in its present form. In our view, it is for the most part expressed so generally that it would be difficult to report meaningfully against its recommendations. Moreover, where it is specific, it sometimes seems unlikely to promote transparency, as in the following 3 examples:

142.( 1) *“The ISC believes voting disclosure must not jeopardise the creation of value through engagement with investee companies. With this in mind, it is appropriate that disclosure should take place only after the relevant general meeting and a time lag in publishing information on voting will be appropriate. This may also reduce risks of inappropriate pressure from special interest groups whose objectives are not aligned with those of clients and / or beneficiaries.”*

143. We agree that often more can be achieved by constructive dialogue with management than by open disputes at company meetings. Sometimes, however, that may not be the case, especially, perhaps, where it is the objectives of management itself that are *“not aligned”* with those of shareholders. In any event, this choice should be left to the discretion of the institutional investor. We do not agree with any general recommendation not to give prior disclosure of an intended vote against management. This would not, for example, be compatible with a public collaborative campaign in advance of an AGM on an issue of concern to a number of shareholders. Here again, we think that the UK could learn from US practice, which is much more transparent with regard to voting intentions.

144.(2) *“Information on voting need only be disclosed once. Where voting is delegated*

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<sup>40</sup> Page 18

*representatives of beneficial owners need not replicate disclosures made by the fund manager, or other third party, unless they choose to override them.”*

145. We are not entirely clear as to the practical implications of this recommendation, but if it is suggesting that the trustees of a pension scheme need not provide their members with information about how their delegated fund managers have voted, then this is unacceptable.

146.(3) *“Where fund managers offer several different products to their clients it should be sufficient for fund managers to make aggregate disclosure of voting instructions given according to the issuer of the shares without specifying the clients whose shares they have voted, the number of the shares in respect of which instructions were given, or the product/scheme that holds the related shares.”*

147. Again, this is not consistent with providing full information about the voting records of specific institutional investors.

## Appendix: the FRC's Issues for Comment

For ease of reference, we summarise below the key comments in our response that relate to the questions asked in Appendix A of the consultation document, together with references to where in this document they can be found.

<b>Section 1: Introduction</b>	<b>FairPensions' response</b>	<b>Paragraphs</b>
The FRC would welcome views on the policy objectives against which the FRC should judge its approach to a Stewardship Code (paragraph 1.14)	<ul style="list-style-type: none"> <li>- The Code should not just establish best practice for those who engage, but should state that it is <u>best practice for investors to engage</u></li> <li>- Stewardship Code must contain a <u>definition of 'stewardship'</u></li> <li>- The primary objectives of stewardship must be to <u>protect end-beneficiaries</u> and <u>serve the wider public interest</u></li> <li>- To this end the Code must apply to investors <u>holdings in all companies, not only UK companies</u></li> <li>- A further stated objective should be to <u>promote stewardship as a means to the enforcement of the Corporate Governance Code;</u></li> </ul>	81  93-101  51-55 62-70, 88  56-60
<b>Section 2: Background and Recent Developments</b>		
The FRC would welcome any insights on lessons which may be learned from experience outside the UK (paragraph 2.18).	<ul style="list-style-type: none"> <li>- Danish and US approaches to ensuring stewardship principles are applied to <u>shares in foreign corporations</u></li> <li>- US approach to <u>transparency</u> in disclosure of voting activity</li> </ul>	58, 122  143
<b>Section 3: The Coverage of the Code</b>		
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 Code could recommend that institutional investors expect such agents to commit to the <u>UNPRI</u> or to <u>other relevant codes of good practice</u>	59-60
<b>Section 4: The Content of the Code</b>		
<ul style="list-style-type: none"> <li>• What are the responsibilities for engagement of institutional investors to the beneficial owners whose interests they represent? Does the ISC Code cover all</li> </ul>	<ul style="list-style-type: none"> <li>- Need for fiduciary investors to adopt an <u>'enlightened stakeholder'</u> approach &amp; recognise the <u>public interest dimension</u> to their activities</li> <li>- Investors have a responsibility to <u>exercise voting rights</u></li> </ul>	62-70  131

<p>the relevant responsibilities?</p> <ul style="list-style-type: none"> <li>• 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?</li> </ul>	<ul style="list-style-type: none"> <li>- Investors must recognise fiduciary obligation to help <u>correct conflicts of interest</u> throughout the investment chain</li> <li>- Responsibilities to end-beneficiaries will not be fully discharged unless: <ul style="list-style-type: none"> <li>• The Code applies to <u>overseas investments</u></li> <li>• <u>End-beneficiaries are represented</u> on the body that oversees the Code</li> </ul> </li> <li>- Managers of <u>pooled funds</u> should be required to give effect to the voting instructions and policies of each client</li> </ul>	<p>105-114</p> <p>57</p> <p>55</p> <p>125-127</p>
<ul style="list-style-type: none"> <li>• Are the respective responsibilities of the different parts of the investment chain sufficiently clear and appropriate?</li> </ul>	<ul style="list-style-type: none"> <li>- We are concerned that the ISC <u>voting disclosure framework</u> appears ambiguous about trustees' responsibilities to beneficiaries</li> <li>- See also our comments on the <u>coverage of the code</u>: investment consultants etc should be covered</li> </ul>	<p>144-145</p> <p>59-60</p>
<ul style="list-style-type: none"> <li>• 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?</li> </ul>	<ul style="list-style-type: none"> <li>- We believe the Code could afford to be more specific in many areas, particularly: <ul style="list-style-type: none"> <li>• <u>definition of 'stewardship'</u> to provide clarity and focus</li> <li>• on <u>conflicts of interest</u> (Principle 2)</li> <li>• on the <u>criteria for escalating engagement</u> (Principle 4)</li> </ul> </li> </ul>	<p>93-101</p> <p>105-114</p> <p>117-120</p>
<ul style="list-style-type: none"> <li>• Are there any parts of the ISC Code where further guidance is needed, or where the existing guidance should be amended? (paragraph 4.2)</li> </ul>	<p>We make suggestions on the existing guidance throughout our comments on the principles.</p> <p>Further guidance should include:</p> <ul style="list-style-type: none"> <li>- A template <u>fund manager mandate</u> dealing with incentive structures</li> <li>- A model <u>voting disclosure form</u></li> <li>- Guidance re policies on <u>conflicts of interest</u></li> </ul>	<p>111</p> <p>137</p> <p>105</p>
<p><b>Section 5: Reporting, Monitoring and Review</b></p>		
<p>The FRC would welcome views on:</p>		
<ul style="list-style-type: none"> <li>• The information that institutional shareholders should disclose publicly and that they should report to</li> </ul>	<ul style="list-style-type: none"> <li>- Integration of <u>ESG issues</u> into investment process</li> <li>- Full disclosure of <u>voting</u> records</li> </ul>	<p>103</p> <p>134-147</p>

clients;		
<ul style="list-style-type: none"> <li>• The arrangements that should be put in place to monitor how institutional shareholders apply and report against the Code; and</li> <li>• The arrangements for reviewing the operation and content of the Code (paragraph 5.2).</li> </ul>	<p>Importance of <u>independent regulatory and monitoring structure</u>:</p> <ul style="list-style-type: none"> <li>- the FRC, as an independent body, must be responsible for regulating the Code</li> </ul> <p>Importance of <u>representation of end-beneficiaries</u> in the oversight and monitoring process</p>	<p>39-42</p> <p>51-55</p>
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).	The form of the current IMA survey may be a good starting-point for the Stewardship Code monitoring system.	139