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Consultation on a Stewardship Code for Institutional Investors

Dear Susannah,

Thank you for giving the Institute of Directors (IoD) the opportunity to comment on your consultative document, published on 19 January 2010. Issues surrounding corporate governance are of considerable interest to the IoD and its membership. We are therefore pleased to present our views on your proposals for a Stewardship Code for Institutional Investors.

About the IoD

Founded in 1903, and granted a Royal charter in 1906, the IoD is an independent, non-party political organisation of 50,000 individual members. Its aim is to serve, support, represent and set standards for directors to enable them to fulfil their leadership responsibilities in creating wealth for the benefit of business and society as a whole. The membership is drawn from right across the business spectrum. 92% of FTSE 100 companies have IoD members on their boards, but the majority of members, some 70%, comprise directors of small and medium-sized enterprises, ranging from long-established businesses to start-up companies.

Initial remarks

The IoD is broadly supportive of the concept of the Stewardship Code as a means of promoting engagement between shareholders and boards.

Engagement is a key component of the UK model of corporate governance, and a source of legitimacy for both directors and institutional investors. However, consistent with the findings of a number of recent studies[1], the IoD believes that there is significant scope for improvement in this area.

In many cases, engagement activity is either absent or tends to focus on a narrow range of issues (e.g. executive remuneration) or the voting process at the annual general meeting. Our view is that engagement should be an ongoing process involving wide-ranging discussion between the company and its main shareholders in respect of key aspects of strategy, risk oversight and governance.

We are hopeful that the Stewardship Code will contribute to an improvement in engagement practices. The proposed Code represents a clear statement of societal expectations with respect to the stewardship

[1] For example: European Commission. *Study on Monitoring and Enforcement Practices in corporate Governance in the Member States*. September 2009.

role of institutional investors. Over time, this may serve to influence the norms and business practices of the fund management industry (including new investors in UK companies, such as sovereign wealth funds). It may also assist the beneficial owners of investment products in demanding a more engaged and long-term ownership strategy from their asset managers.

However, it is important to be realistic about the likely impact of the Stewardship Code. There are a number of reasons why its effect on investment behaviour is likely to be relatively limited (at least in the short-term).

- The most important cause of poor engagement between shareholders and boards in the UK is the diversified portfolio strategy of most institutional fund managers. Such institutions hold relatively small percentage stakes in large numbers of listed companies. As a result, they lack the incentive to meaningful engage with any individual company.

- Most institutional fund managers are deterred from devoting significant resources to engagement due to the costs involved and the "free-rider" benefits that competitor fund managers would gain as a result of such activities.

- Many active fund managers are subject to relatively short-term performance pressures. In most cases, this leads them to concentrate their efforts (and human capital) on stock-picking and equity trading rather than long-term engagement with their companies under ownership.

None of these underlying problems is overcome by the introduction of the Stewardship Code.

Furthermore, there are a number of practical problems with the functioning of the Stewardship Code, which may inhibit its impact on investor behaviour.

- It cannot necessarily be assumed that actual or potential beneficial owners of shares (e.g. trustees, policy holders, retail investors) will demand a stewardship orientation from their investment suppliers. Beneficiaries may simply not understand or accept the accountability role that the Code is inviting them to play.

- Stewardship activities may in fact be seen as exerting a negative impact on investment returns (e.g. through higher administration costs or by inhibiting the flexibility of the investment process). If such a perception emerges amongst beneficial owners, a stewardship orientation may be a source of competitive disadvantage for institutional investors.

- The modern fund management industry has constructed a long and complex investment chain between money managers and ultimate beneficial owners (e.g. involving proxy voting agencies, investment consultants, custodians, and other forms of intermediary). This distorts lines of accountability between fund managers and beneficial owners.

- Non-UK shareholders will not be required to "comply or explain" in respect of the Stewardship Code. As of 2008, such investors held more than 40% of the UK stock market. Consequently, the Stewardship Code will only apply to a relatively narrow section of UK company ownership.

In summary, although it represents a worthwhile step for UK corporate governance, the Stewardship Code faces an uphill battle in order to exert a meaningful effect on board-shareholder engagement.

In order to mitigate these obstacles, **it will be important that the launch of the Code is accompanied by a major publicity and induction programme for investment industry participants at all stages of the investment chain.** Such an implementation programme is likely to be as important a success factor as the precise wording of the Code.

In particular, beneficial owners and their representatives must rapidly gain an appreciation of the benefits of stewardship and their specific role in increasing the accountability of fund managers. To that end, a detailed treatment of the Code and its implications should be incorporated into relevant training and certification programmes undertaken by trustees, beneficiaries and their advisers.

The training and induction of investment consultants providing an advisory service to beneficial owners on investment strategy is of particular importance. If investment consultants are not knowledgeable or supportive in respect of the objectives of the Stewardship Code – and do not highlight engagement issues as part of their reporting to clients – the impact of the Stewardship Code will be limited.

It is also essential to promote the international acceptance of stewardship code principles. A significant number of non-domestic investors must be persuaded to adhere to the spirit of the Code. Without the voluntary support of non-UK investors, the impact of the Code on overall standards of UK corporate governance is likely to be limited.

Responses on specific issues

We are broadly supportive of existing proposals in relation to the Stewardship Code. However, we have a number of proposals to make in respect of specific issues.

Role of the FRC

In order to avoid any perception of conflicts of interest, it is important that the Code is reviewed and monitored by an independent body (standing outside the investment management industry).

We believe that the FRC – as an independent regulatory body - is the appropriate organisation to take over the administration of the Stewardship Code.

The FRC should conduct its own surveys and studies of engagement practices amongst institutional investors. It should not rely on surveys undertaken by fund management trade bodies, e.g. the IMA survey.

Content of the Code

Areas where we would favour changes to the existing ISC Code include the following:

Principle 1: Disclosure of stewardship policy
Guidance, first bullet point.

We believe that the existing language concerning the need for an active dialogue between shareholders and boards is too tentative.

The current wording is as follows: “In order for monitoring to be effective, where necessary, an active dialogue may need to be entered into with the investee company’s board.”

We feel that there should be a stronger statement in favour of active dialogue. For example, as follows:

“In order for monitoring to be effective, in most instances an active dialogue will need to be entered into with the investee company’s board”.

Principle 7: Reporting on stewardship and voting activities by Institutional Investors
Guidance, first paragraph.

The ISC Code is currently inadequately prescriptive about how investors should report on their stewardship and voting activities.

The wording is currently as follows: “The particular information reported, including the format in which details of how votes have been cast are be presented, should be a matter for agreement between agents and their principals.” [2]

In many cases, there is likely to be a significant asymmetry in the expertise and power of so-called agents (e.g. institutional investors) and so-called principals (e.g. the beneficial owner or trustees acting for beneficial owners). Beneficial owners may not have a clear idea of what sort of stewardship information should be demanded from an institutional investor, and may feel in a weak position relative to a large corporate organisation.

Consequently, it is important that the Code and any associated guidance should provide greater clarity regarding how stewardship and voting activities should be disclosed by institutional investors. This guidance may have to be relatively detailed, and should developed in a way that takes into account the differing levels of financial sophistication of beneficial owners.

As with other forms of financial reporting, a minimum level of transparency is necessary in order to facilitate the role of investment beneficiaries in holding institutional investors to account.

Securities lending and borrowing

The ISC code does not discuss the securities lending and borrowing practices of institutional investors. Such practices may exert a negative impact on the ability of investors to exercise a stewardship role over their investee companies.

Consequently, the Stewardship Code should define best practice principles in this area. A starting point is the International Corporate Governance Network’s Securities Lending Code of Best Practice (2007). This emphasizes the important of transparency, consistency and responsibility in securities lending practices. Relevant principles for the Stewardship Code are likely to include the following:

- Institutional shareholders should have a clear and disclosed policy with respect to the lending of shareholdings;
- Lending policy should be mandated by the ultimate beneficial owners of the shares;
- Where lending activity may alter the risk characteristics of a portfolio, the investor’s investment policy should state the extent to which this is permitted;
- The returns from lending should be disclosed separately from other investment returns when reporting to clients or beneficiaries;
- It is bad practice to borrow shares for the purpose of shareholder voting.

Intended audience of disclosures

The existing focus of the ISC Code is for disclosures to be made by institutional investors for the benefit of beneficial owners.

However, in our view, investee companies are also a key audience. Such disclosures would assist boards and shareholders in initiating a process of meaningful engagement.

For example, institutional investors making a significant investment in a listed company beyond a certain threshold (e.g. 1-3% of the market capitalisation) could be required to write directly to the chairman of that company and provide details of the policy and mechanics of their stewardship activities in respect of investee companies.

[2] There is currently a typographical error in the middle of the sentence.

Furthermore, they may also wish to provide the chairman with an indication of their initial thinking on the main engagement issues that may be relevant to that particular company.

Thank you once again for inviting the Institute of Directors to participate in this consultation. We hope you find our comments useful.

Yours sincerely,

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