

16 April 2010

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Dear Ms Haan

CONSULTATION ON A STEWARDSHIP CODE FOR INSTITUTIONAL INVESTORS

This submission addresses the policy objectives behind the adoption of the Stewardship Code and the balance between principles and guidance in the Stewardship Code itself.

Policy objectives

Paragraph 1.14 of the consultation document sets out five policy objectives for the Stewardship Code. The two primary public policy interests noted in paragraph 5.1 are also important policy objectives for the Stewardship Code. ***It is recommended that these two policy interests be included with the policy objectives noted in paragraph 1.14.***

Much of the Stewardship Code as currently drafted focuses on engagement and voting. How will the FRC assess whether the Stewardship Code has promoted better understanding and communication between companies and investors (the first of the two public policy interests)? The measurements of outcomes from adopting the Stewardship Code should be specified at this stage and are suggested by the Stewardship Code itself. The 'ends' to which stewardship is directed are described in the current draft of the Stewardship Code as 'improving long-term returns to shareholders, reducing the risk of catastrophic outcomes due to bad strategic decisions, and helping the efficient exercise of governance responsibilities'. Identifying how best to measure these outcomes would also help the FRC clarify how it might monitor the Stewardship Code. It is likely that something additional to external surveys such as the IMA's survey of engagement and voting practices will be necessary.

The second public policy interest, *to assist the investment chain to operate more effectively*, requires a different set of solutions. As currently worded, the Stewardship Code does not deal explicitly with this issue. ***It is recommended that the Stewardship Code be amended to include further principles that explicitly address this policy objective of improving the efficiency of the investment chain.***

Engagement and its link to the investment process

This is a critical issue: the Stewardship Code and its endorsement by the FRC could well encourage engagement as an end in itself, rather than a means to the ends identified in the Stewardship Code. There is evidence from executive remuneration of a separation between engagement processes and investment processes. My small sample interview research in the UK (2008) indicates that certain proxy advisors are preferred because *they* engage with investee company management. Other institutional investors retain the services of a governance advisory firm that engages with investee company management on behalf of a number of institutional investors. In other words, the 'investment process' is undertaken by one entity, while the 'engagement process' is undertaken by another. It is not clear how these two separate processes are linked.

It is recommended that the FRC consider carefully this particular policy objective.

Sufficient disclosure for prospective institutional investor clients

This policy objective should be achieved within a competitive market for institutional investment services, not through initiatives that involve the FRC. ***It is recommended that this policy objective be deleted from the list identified in [1.14].***

Content of the Stewardship Code [section 4]

The right balance between principles and guidance is correctly identified in the consultation document as crucial to the operation of the Code. Overly detailed guidance can paradoxically undermine the thrust of principles-based regulation. Executive remuneration provides evidence of how important this balance is. Detailed guidance from institutional investors on remuneration structures and performance conditions, together with their engagement practices and voting behaviour on executive remuneration issues, influenced the practices companies adopted. In other words, there is a likely to be a strong link between

- (i) the level of prescription in the Stewardship Code;
- (ii) how institutional investors disclose their compliance or explain their non-compliance;
- (iii) how the FSA will monitor and sanction non-disclosure by authorised asset managers (or indeed sanctions poor explanations of 'how' the asset manager commits to the Stewardship Code);
- (iv) how the FRC monitors and reports on the adoption of the Code (will it endorse some practices over others, for example?)

and the stewardship practices institutional investors adopt. The FRC and FSA should ensure they understand this link before the FRC settles on the final form of the Stewardship Code; and the FSA settles its own rules on disclosure.

Yours sincerely

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