



**Local Authority
Pension Fund
Forum**

Financial Reporting Council
Consultation on a Stewardship Code
for Institutional Investors

***Response by the
Local Authority Pension Fund Forum***

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FINANCIAL REPORTING COUNCIL
CONSULTATION ON A STEWARDSHIP CODE
FOR INSTITUTIONAL INVESTORS

1. Background

LAPFF, which was set up in 1991, is a voluntary association of 52 local authority pension funds based in the UK. LAPFF exists 'to promote the investment interests of local authority pension funds, and to maximise their influence as shareholders to promote corporate social responsibility and high standards of corporate governance amongst the companies in which they invest.' The Forum's members currently have combined assets of about £100 billion. PIRC is the Research and Engagement Partner to LAPFF.

The Forum has taken the opportunity below to provide our view on those consultation document and consultation questions, which we consider relevant to our activities.

2. General comments

More engagement versus more effective engagement

We agree that more effective engagement should improve the governance and performance of investee companies, assist the efficient operation of capital markets and increase confidence in business.

Nonetheless, we believe the FRC should place emphasis on the quality of shareholder engagement rather than on the quantity. More engagement alone is unlikely to achieve the objectives listed immediately above. Indeed, to the extent that the ISC Code encourages investment managers to commit greater resources to engagement, more rigorous oversight of its application may simply induce low-return expenditure at both the investment manager and investee company ends of the investment chain.

In our opinion, only *effective engagement* is likely to achieve the Code's objectives – and we are not convinced that either current survey practices or those inferred in this document adequately measure the quality of investment managers' engagement activities, or provide guidance in this regard.

Fund manager disclosure

We agree that fund managers should clearly disclose their business models, so that beneficial shareholders are able to make an informed choice when placing a fund management mandate.

We also believe the FRC should state this requirement more specifically. The requirement for a fund manager to disclose its business model is open to

interpretation. We recommend that the language of this requirement extends to disclosure of the detail of fund managers' investment processes, which includes disclosure of portfolio turnover levels (average holding periods) stated according to a standard definition of portfolio turnover. Given the close link between the Code's objective of improving long-term shareholder returns through engagement it appears to us to be a reasonable request that fund managers who subscribe to the Code evidence that their holding periods are commensurately long-term.

Third party input

We agree that third party input is important to the proper functioning of the Code and that the Code should be ratified by the FRC.

Our concern in this regard would be whether the FRC has the skills and resources required to go beyond a tick box approach to measuring compliance with the Code in its proposed annual engagement survey.

Policy objectives

We support the policy objectives stated by the FRC and suggest adding an objective in the area of promoting an optimal rather than maximum level of engagement (engagement quality rather than quantity).

Also welcome in the Code would be reference to the fiduciary duty required of trustees and investment managers whose responsibility is delegated by beneficial owners. Recent developments on the requirement under this duty to incorporate material Environmental Social and Governance (ESG) issues into the investment process are explored in the 'Freshfields II' report¹. The report's principle author, Quayle Watchman Consulting, a recognised fiduciary duty expert concludes that institutional investors have a duty of care to proactively raise ESG considerations, stating that those that fail to do so, create "a very real risk that they will be sued for negligence".

The Stewardship Code should go beyond governance issues that were the core focus of the combined code to include all relevant sustainability matters (notably the environmental and social – E&S). To ignore their possible material impact on shareholder value and their significance as engagement topics would be an oversight.

Conflicting interests

The ISC Code asserts that being underweight is not, of itself, a reason for an institutional shareholder to not engage with an investee company. However, whilst the Code aims to encourage integration of engagement activities in the

¹ <http://www.unepfi.org/fileadmin/documents/fiduciaryII.pdf>

Fiduciary responsibility Legal and practical aspects of integrating environmental, social and governance issues into institutional investment, United Nations Environment Programme Finance Initiative July 2009

investment process, it does not make it clear how an institutional shareholder should resolve the conflict between doing this and engaging with an investee company to improve its performance when the institution has an underweight position in its shares.

3. Specific observations

- **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.**

To some extent it is likely embracing the spirit of the code will be done naturally by agents in order to meet clients' needs. As voting services and other aspects of engagement and investment consultation is often outsourced by LAPFF and its members the Forum would welcome these participants embracing the spirit of the Stewardship Code.

- **What are the responsibilities for engagement of institutional shareholders to the beneficial owners whose interests they represent?**

In our opinion this depends on the 'contract' entered into between the investment manager and the asset owner.

Our ideal would be for investment managers to evidence that they are saving and/or acting like part-owners of investee companies on behalf of their beneficial owners, using a clear definition of what it means to do so, and the investment behaviours this suggests.

As this pertains to engagement, we believe it is the responsibility of institutional shareholders to engage with investee companies to enhance the allocation of capital within the investment chain and thereby improve the return on beneficial owners' savings.

Institutional shareholders can and should encourage this by seeking to raise specific and general standards of corporate governance.

Nonetheless, we do not believe this (or any similar) view should exclude other investment philosophies or practices. Since the collective intelligence of the market is likely to break down when all participants think and act in the same fashion, we consider diversity to be essential to market efficiency.

As mentioned in the general comments a reference to fiduciary duty and institutional shareholders and asset managers obligations would be welcomed.

- **Does the ISC Code cover all the relevant responsibilities?**

We do not believe ISC Code encourages investment managers to disclose how their investment processes are consistent with its objective of enhancing the quality of the dialogue of institutional investors with companies to help improve long-term returns to shareholders and reducing the risk of catastrophic outcomes due to bad strategic decisions (or what might be described as ‘ownership principles’).

In the absence of this, engagement processes can simply be ‘bolted on’ to investment processes that are inconsistent with the principles of ownership that institutional shareholders who subscribe to the Code should embrace. More specific guidance towards best practice on how institutional shareholders specifically address relevant ESG concerns would be beneficial particularly when it is incorporated into the existing investment decision making process.

In addition, we believe shareholders also owe duties to fellow shareholders. By engaging with investee companies we believe institutional shareholders should not seek to expropriate existing or future owners by favouring their interests.

- **What are the responsibilities for engagement of institutional shareholders to the UK listed companies in which they invest?**

We believe institutional shareholders that choose to engage with investee companies have a responsibility to the companies they engage with to add value to the engagement ‘target’ rather than encourage a compliance mindset within the target that risks investment in low-return activities.

We note in this regard the Code’s emphasis on improving long-term returns to shareholders and reducing the risk of catastrophic outcomes due to bad strategic decisions.

We believe equal emphasis should be placed on the relationship between better company performance and better long-term returns to shareholders and on the role of institutional shareholders in promoting the latter by encouraging the former.

We also believe the Code reflects an institutional shareholder focus on risk mitigation and engagement to prevent or repair (either stock market or fundamental corporate) underperformance. In our opinion, it is equally important for institutional shareholders to recognise best practice in corporate governance and relevant sustainability areas where they find it and to identify

opportunities for companies that are already 'good at governance' and which are performing well, to encourage additional value added behaviours.

- **Are the respective responsibilities of the different parts of the investment chain sufficiently clear and appropriate?**

[No comment on this element]

- **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?**

See above. We believe the Code should encourage greater transparency in regard to how investment processes comply with the ownership principles implied by the Code.

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

See above. We believe the Code should hold a better balance between an objective of mitigating risk in investee companies and one of encouraging investee companies to create competitive advantage through better management of relevant environmental, social and governance matters.

We believe encouraging such a balance is likely to promote a more constructive perception of engagement within UK listed companies and lead to improvements that result in better long-term performance of the engagement target.

See above – investment management process

See above – inclusion of reference to ESG matters and fiduciary duty.

Views are invited on whether the ISC Code adequately covers the content of Section E of the Combined Code.

- **Section E of the Combined Code refers to a dialogue based on the mutual understanding of objectives, whereas the ISC Code refers to a dialogue to help improve long-term returns to shareholders, reduce the risk of catastrophic outcomes due to bad strategic decisions, and help with the efficient exercise of governance responsibilities.**

We generally believe the more specific the objective(s) in any code is/are, the less room exists for differences in interpretation. We therefore approve of the ISC Code's greater specificity versus the Combined Code.

Nonetheless, the ISC Code currently leaves room for ambiguity. For example, it is not necessarily clear what “the efficient exercise of governance responsibilities” looks like.

- **The Combined Code recommends that investors set out their reasons in writing where they do not accept explanations provided by the company, but the ISC Code does not. Nor is there any mention in the ISC Code of the need to bear in mind the size and complexity of the company concerned and the nature of the risks and challenges it faces in judging an explanation.**

In our opinion this is an oversight on behalf of the Code that unfairly tilts the playing field in favour of the investment management industry. We are in favour of full disclosure of either side of any comply or explain guidelines and believe this is likely to encourage more effective (and constructive) engagement.

- **The provisions of Section E of the Combined Code state that “major shareholders should attend AGMs where appropriate and practicable”, but there is no mention of attendance at AGMs in the ISC Code. Some respondents to the review of the Combined Code considered that this was unrealistic and impractical, as large institutional investors will hold shares in many hundreds of companies, and as a result attendance at AGMs by institutional as opposed to private shareholders was only likely in exceptional circumstances.**

We agree that generalised attendance at AGMs is unrealistic and impractical. AGM attendance can be appropriate and provides an open venue for shareholders to voice concerns. It should not be ruled out as part of the engagement process.

In our experience, effective engagement is time consuming and labour intensive. In order to add value at the investee company level and at the asset owner or investment manager level this implies engagement ‘targets’ need to be carefully selected versus the alternative of seeking to engage with all listed companies.

- **The ISC Code contains no explicit recommendations on disclosure in relation to Principle 3 (“Institutional investors should monitor investee companies”) and Principle 4 (“Institutional investors should establish clear guidelines on when and how they will escalate their activities”). Views are invited on whether public disclosure of such information is appropriate and useful, and whether other information might also usefully be disclosed.**

There are two purposes for institutional investor disclosure in relation to the principles of both the Combined Code and the ISC code. First is the need for asset managers who subscribe to the Codes to demonstrate their commitment to the principles through their behaviours. Too many asset manager pay lip-service to engagement and provide no evidence of their behaviours in this regard. Additionally, their clients and the market as a whole have no other significant opportunity to hold them to account for such behaviours. It seems to us to be appropriate for the Stewardship Code to set out the broad framework for disclosure required to fulfil the purposes suggested above.

In addition, we believe that asset owners that care about engagement should be prepared to conduct their own research or access third party research that goes beyond the detail implied by this element of the Code.

Views are invited on the merits of the current IMA survey and other possible approaches to monitoring the overall application of the Code.

One of the principal findings of the latest IMA survey is that “although it is clear that firms engaged on the issues [highlighted in the survey], it is also apparent that there was a tendency for them to be ignored.”²

In our opinion this finding strikes at the heart of the ‘more engagement versus more effective engagement’ issue.

The IMA has now conducted five surveys of fund managers’ engagement with companies since 2003. To the extent such monitoring has encouraged more engagement it is not clear it has encouraged more effective engagement. One reason for this may be that, like many surveys, it appears to measure behaviours and processes that are relatively easy to measure rather than outcomes, either in the contribution of engagement activities to buy, sell and valuation decisions or in the final effects of engagement at the target level.

In addition, IMA presents its survey results as reportage rather than analysis and it falls short of providing an evaluation statement in regard to its findings.

In our opinion, the IMA survey is not an adequate mechanism for assessing the effective adherence to the proposed Stewardship Code, and suggests that the FRC undertake such a survey itself, or commission from an independent body to highlight where and how subscribers to the Code may improve the effectiveness of their engagement.

It may also be the case that an independent third party could survey investee companies to determine whether they believe engagement is effective in meeting

² IMA Survey of Fund Managers’ Engagement with Companies for the two years ended 30 June 2008

the current (and perhaps expanded) objectives of the Code – and to give their verdict on whether their experience of engagement by institutions that subscribe to the Code matches the Code’s objectives.

As a signatory to the UN Principles for Responsible Investment, LAPFF appreciates their annual survey’s evaluation of engagement and the incorporation of Environmental Social and Governance concerns into the investment process. The survey is a mix of clearly defined questions and answers as well as leaving space for open comment. Although still in its early days the FRC may look to incorporate PRI results and analysis in their evaluation of adherence to the code.

Subject to views expressed in response to this consultation, the FRC proposes to introduce a review process for the Stewardship Code equivalent to that already in place for the Combined Code: that is, reviews would in the normal course of events be undertaken every two or three years, would involve public consultation with those applying the Code and other interested parties, and would focus on the overall effectiveness of the Code and the “comply or explain” mechanism rather than its application by individual investors. Views are invited on this proposed approach.

See above. We believe the FRC should seek to make a distinction between measuring the quantity of engagement and the quality of engagement, and between measuring the resources dedicated to engagement and the processes that underpin them, and the outcomes they induce.

- **The information that institutional shareholders should make publicly available and that they should report to clients.**

We believe that the FRC should consider drawing up an appropriate framework in regard to public disclosure. In our view it is considered desirable to require institutional shareholders to disclose the outcomes of their engagement activities (to the extent that these can be measured and attributed to individual or collaborating institutions). However, the extent of public disclosure should be wary of impinging on an institutional shareholder’s ability to build the kind of relationship required with target companies that enables effective engagement.

With regard to the information institutional shareholders should report to clients, we believe that an appropriate framework should be set out in the investment management agreements agreed between the two parties.

In 2009, LAPFF undertook a survey of voting disclosure of UK asset managers and concluded that though it was clear that there has been an increasing trend towards greater disclosure of voting data, it is not clear whether this increase has been driven by the publication of the ISC

framework on disclosure, or was simply the continuation of the gradual trend towards greater disclosure.

In its analysis of the survey results, LAPFF found that the simple fact that a majority disclose some data does not tell the whole story. There continues to be a dramatic variance in the nature and depth of disclosure, and this poses considerable problems for beneficiaries or other interested parties. The lack of a uniform pattern in disclosures makes any comparison or analysis extremely difficult. Because of variations in the depth and timeliness of disclosures, the Forum was only able to find data for about a third of its target group in respect of the 2008 season, and a substantially smaller number in 2007 and 2006. If the point of disclosure is to provide clients with an informed picture of how asset managers are exercising ownership, it is hard not to conclude that the current voluntary regime is not an effective approach.

One reason to query the impact of the ISC framework on disclosure is the behaviour of non-disclosing asset managers. The framework document states that “Where their overall approach is not to disclose, the ISC recommends that they provide a reasoned explanation of that policy.” Yet none of the managers reviewed in this study which do not disclose appear to make any statement explaining their policy. Again this suggests that the existing voluntary regime does not function effectively.

In short the current regime is not ‘fit for purpose’. As the Economic Secretary to the Treasury stated in 2007, “savers, as ultimate owners, have a right to know how their agents are managing their investment”³. Yet the voluntary approach to disclosure does not meet such an aspiration. All of this points towards the need for a mandatory approach to voting disclosure. At a stroke the Government could stipulate the nature and timeliness of disclosure, addressing the problems outlined above. It would also greatly increase the voting data available, by forcing those managers currently providing nothing to disclose.

The experience of the US market suggests that once a mandatory regime is in place, tools can be developed to enable beneficiaries and other interested parties to make comparisons between managers.

The Government took a reserve power in the Companies Act which would enable it to mandate public disclosure of voting records⁴. In the wake of the financial crisis, and the scrutiny of the shareholder role in governance, the public interest argument in favour of disclosure is compelling. In light of the analysis in this paper, it is clear that the UK’s voluntary approach to disclosure is ineffective. Therefore the logical solution is for the Government to exercise its reserve power.

³ http://www.hm-treasury.gov.uk/speech_est_150307.htm

⁴ http://www.opsi.gov.uk/acts/acts2006/ukpga_20060046_en_77#pt44-pb2-l1g1277

- **The arrangements that should be put in place to monitor how institutional shareholders apply and report against the Code; and the arrangements for reviewing the operation and content of the Code.**

See our comments above in regard to current IMA and UN PRI practices.