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Response to the Financial Reporting Council's consultation on the Stewardship Code for Institutional Investors

Dear Ms Haan,

Thank you for the opportunity to comment on the proposed stewardship code for institutional investors.

Nestor Advisors Ltd is a London-based consultancy focusing exclusively on corporate governance. Our clients are based throughout EMEA and assignments range from providing companies with tailored advice on board effectiveness, governance structure and organisational controls. Given that perspective, we commend the movement towards a stewardship code and the considerable efforts taken to produce the Institutional Shareholder Committee Principles (the "Principles"). The UK gained a leading, international standard-setting role when establishing the Combined Code, and continues to fortify its leadership position in pursuing a stewardship code for institutional investors.

Transforming the Principles into a stewardship code

The current draft of the Principles has a number of attributes including

- the promotion of transparency, disclosure and accountability,
- the flexibility of the Principles and the recognition in the introductory section that institutional investors' approach to engagement may vary depending on their resources and investment strategy,
- the view that institutional investors' primary responsibility is to deliver against terms agreed with clients,

- an understanding that engagement can help improve long-term results to shareholders and reduce the risk of catastrophic outcomes due to bad strategic decisions, and
- the view that institutional investors should seek to vote all shares held and should not automatically support the board.

However, despite those attributes, the Principles do not yet constitute a stewardship code. In our view, to become such a code, the Principles should be improved by

- clearly and pragmatically defining the objectives of stewardship by institutional investors,
- clearly and coherently defining the scope of the activities that constitute stewardship by institutional investors,
- providing more best practice guidance than the Principles currently do regarding the
 - execution of institutional investors’ governance responsibilities,
 - organisation of institutional investors’ engagement activities, and
 - methods for collective engagement.

Defining the objectives of engagement

The Principles appear to suggest that the objectives of institutional investor engagement are to

- “help improve the 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”.

While we agree with each of these, we are concerned that firstly, the objectives are not clearly articulated, and secondly, that the objectives articulated (particularly the objective of reducing the risk of catastrophic outcomes) may be construed in a manner that creates unrealistic expectations. Instead, the code on stewardship should clearly recognise the limitations as well as the real potential of stewardship by institutional investors.

Recognising the limit and potential of institutional investor engagement

A spill-over effect of the financial crisis is the growing demand and perhaps unrealistic expectations associated with institutional investor engagement. The rationale seems to be that more effective institutional investor engagement would have prevented the failures of banks. Shareholders do, it is true, have the authority to make decisions regarding matters that a company’s articles of association reserves for shareholder vote. Beyond those narrowly defined issues, we query whether institutional investors

can *directly* change a course of events. After all, as the Principles appropriately recognise, institutional investors must rely upon publicly available information.

At the foundation of corporate governance is a recognition of the limitations of shareholders' stewardship, namely that the separation of ownership and management creates an agency problem. The solution to this problem—particularly for listed companies with diversified holdings—is a board that effectively oversees, monitors and controls the company and the activities of its chief executive. It is the *board* and not the investor of a company with a diversified shareholder-base that is the steward of the company.

The investor, however, should be seen as the steward of the board. Shareholders oversee and, through their vote to determine board appointments, have authority to check the exercise of power of the board, just as the board oversees and, where appropriate, limits the exercise of authority of the chief executive. This shareholder role should not be underestimated. A competent, engaged board that challenges its executive can produce better leadership of the company and curb potential executive excesses. Better exercise of this shareholder responsibility to oversee the board's effectiveness, particularly by institutional investors, may have resulted in better board leadership that may have curbed some of the excesses that contributed to the financial crisis that began in August 2007. Therefore, a primary objective of institutional investors' stewardship role should be to ensure that its investee companies are governed by an effective board.

Yet, this is certainly not the only objective of institutional investors' stewardship. Stewardship should—and will in any event—reflect some of the interests of the institutional investor, which will be to seek to increase the returns delivered to its clients in the manner that the client has requested. Institutional investors will certainly then continue to pursue dialogue with executives and board members about the investee company's fundamental performance, share price performance, business strategy, and management quality and leadership including succession planning. The objective of this dialogue is two-fold. Firstly, it provides additional information upon which the investor can make decisions with respect to holding or unwinding a position. Secondly, on matters on which shareholders do not vote, shareholders may seek to influence decisions by the chief executive and, where appropriate, the board.

In summary, the stewardship code should

- clearly identify investors' role as stewards of the board and the board's oversight of the company. This role should be balanced against the institutional investors' fiduciary duty to its clients, and
- recommend that each institutional investor clearly articulates what it views as the objectives of its stewardship activities

- provide guidance that the objectives of stewardship may be to
 - help improve the long-term returns to shareholders,
 - increase the effectiveness of the boards of investee companies,
 - influence decisions of the board and executive that the institutional investor deems to be significant, and
 - provide another source of information upon which institutional investors can then base their decisions regarding votes or to hold or unwind a position, as well as
- recommend (since a stewardship code would exist to promote the efficacy of the Combined Code) that at a minimum institutional investors set as an objective of their institutional investor engagement activities the promotion of the effectiveness of the board

Defining the scope of institutional investors' stewardship activities

Both the Combined Code and the Principles suggest that engagement is a dialogue between investor and the company. With this, we agree. Going beyond the Combined Code, the Principles further appears to suggest that stewardship involves monitoring, dialogue, intervention and voting. With this, we also agree. However, we find problematic the Principles' description of the focus of stewardship, in that the Principles are both inconsistent and incomplete.

Consistency: crisis versus normal course

The Principles present two different views of the scope of these activities: a narrow scope proposed for activities that relate to monitoring in the normal course, and a broader scope is given for activities related to intervening in the event of a crisis. Activities related to monitoring include ensuring that investee company boards and sub-committee structures are effective, and that independent directors provide adequate oversight. In contrast, in the event of a crisis, the Principles recommend that institutional investors consider intervention when they have concerns about the company's strategy and performance, its governance or its approach to the risks arising from social and environmental matters.

What is unclear is why a guide to best practice (as the Principles seek to be) would recommend an increase in the scope of activities at a time of crisis? Why would it be best practice for an investor to intervene in a time of crisis regarding issues that the investor was not monitoring prior thereto? Why would it be best practice to recommend potentially ill-informed intervention at a time during which senior management and the board should be focused on putting out fires and safeguarding the company as a going concern? Similarly, why should the investor seek to speak with

the chairman then and not prior to a crisis, as the current construct of the document suggest? How does the investor detect problems “at an early stage,” as recommended in Principle 3, if the investor is not making contact with the chairman and/or senior independent director as a part of its monitoring process during the normal course? A simple solution would be to align the issues to be monitored with the issues that may require intervention.

Further, we would recommend that the stewardship code (in the style of the Combined Code which is not prescriptive)

- provide institutional investors with guidance regarding the focus of stewardship activities, such as regarding an investee company’s fundamental performance, share price performance, business strategy, management quality and leadership including succession planning, and board effectiveness
- provide best practice guidance suggesting that the institutional investor monitor the same issues that may require intervention
- provide best practice guidance that the institutional investor seek to have dialogue with the chairman, senior independent director and/or chairs of board committee of companies in which it holds a substantial stake on a regular basis, and not just during times of crisis. If such a recommendation is made, the code should provide further guidance on what is meant by a “substantial” stake, which may be defined by the investor as a relatively significant holding within its portfolio and/or greater than a defined percentage of the company’s shares outstanding.

Further best practice guidance on stewardship

Following from the view expressed above regarding the limitations and potential of stewardship by institutional investors, the stewardship code would be strengthened by providing additional guidance regarding best practice, in the areas of governance activities, the investors’ internal organisational arrangements of stewardship activities, and on collective engagement.

Governance activities

The stewardship code would be strengthened if it provided best practice guidance regarding the following matters.

- Institutional investors’ oversight of board composition

- Specifically, the code could recommend that
 - institutional investors seek to express views regarding the board’s composition to the chairman and/or senior independent director of a board and/or chair of the board’s nominating committee at an early stage in the planning process, and before the shortlist of candidates has been prepared
 - institutional investors consider the fit of nominee’s skills and profile in relation to the skills of existing members of the board rather than evaluating the attribute of a candidate on a stand-alone basis.
- Institutional investors’ interaction with the board
 - Specifically, the code could recommend that institutional investors seek to have dialogue on matters of stewardship on a regular basis with at least the chairman and senior independent director of companies in which the investor owns a significant stake or the holding constitutes a significant a portion of the investor’s holdings.
- Institutional investors’ assessment of the board’s efficacy
 - The code would benefit from the inclusion of Supporting Principles of sections E.2 of the Combined Code

Investors’ internal organisation of its stewardship activities

The Principles suggests that institutional investors disclose their internal arrangements, including how stewardship is integrated within the wider investment process, but it does not provide guidance on what constitutes best practice internal arrangements.

The stewardship code would be strengthened if it provided best practice guidance regarding

- the investor having persons of sufficient seniority responsible for dialogue with members of the board
- the investor coordinating the positions of its governance and investment teams so as to minimise delivering conflicting messages to companies.

Concerns regarding each of these were raised in a JCA Group survey commissioned by the Financial Reporting Council in last year's review of the Combined Code¹. While some firms are stronger than others in the areas of stewardship, it appears that it is not uncommon for institutional investors to lack sufficient internal coordination and for governance personnel to lack sufficient preparation and/or gravitas to influence board and executive decisions.

Collective engagement

A lingering concern regarding the code is that while promoting best practice, transparency and accountability are useful, if the fundamental obstacles to engagement are not addressed, little change may occur.

Fundamental obstacles to better stewardship include cost (versus quantifiable return) and the resource constraints of institutional investors. Incentives to address these obstacles such as enhanced voting rights or dividends for shareholders who engage would fall outside the scope of a stewardship code as they would require the adoption of new laws or regulations.

However, there are also concerns regarding the utility of engagement activities. For example, companies often express frustration with investors' lack of interest in dialogue regarding issues of governance and with the lack of coordination between the governance and investment team of investment firms. Companies are in turn criticised by investors for failing to communicate the extent to which they act upon engagement messages from shareholders. Investors are also unsure of the extent to which executives and chairs provide non-executives with feedback of shareholders' views.

Collective engagement can help address some of these concerns and improve the effectiveness of engagement activities. We therefore recommend that the FRC—either in the stewardship code, if appropriate, or elsewhere—engage companies and institutional investors in constructive dialogue regarding possible forms of collective engagement. These may be initiative by the company or shareholders and, consistent with the 'comply or explain model', it would be for the company or its shareholders to determine what model of collective engagement is most appropriate.

1 J. Hall & T. O'Malley, July 2009. *Corporate governance and the effectiveness of shareholder engagement: a study of investor, company and adviser perspectives conducted by the JCA Group for the Financial Reporting Council*

One approach is an adaptation of the Swedish shareholders' nominating committee, as advocated by Tomorrow's Company in its report *"Tomorrow's corporate governance: Bridging the UK engagement gap through Swedish-style nomination committees"*².

Another approach, as advocated by Nestor Advisors in the ICGN's 2009 Yearbook³, is the creation of a shareholder advisory committee, to which we refer in the article as a shareholder council. The primary difference between the shareholder nominating committee and the shareholder council is that the former extracts from the board its responsibilities regarding the nominating process. In contrast, the shareholder council would leave intact the current governance arrangements but serve as a more flexible forum for engagement on a broader range of issues that are of import to institutional shareholders.

The shareholder council would be a consultative body comprised of investors with significant holdings preferably meeting at least three times each year with a number of members of the board, such as chairman, senior independent director, and chairs of board committees. These shareholder council meetings could serve as a venue for institutional investors to express views to not only the board chair and non-executive directors but also as importantly to their investor peers. Meetings could focus on governance and other long-term and strategic issues, so as to complement the short-term focus of discussions surrounding earnings reports.

The shareholder council would allow for greater interaction between shareholders and board chairs, senior independent directors and non-executive directors with key positions on board committees. This interaction would provide shareholders with valuable insight regarding the functioning of the board, its group dynamic and perhaps also the abilities of board members, on whose directorship the shareholder would then be in a better position to opine.

As discussed in detail in the ICGN article, which we attach hereto, the shareholder council proposal is derived from specific concerns with the attributes of shareholder's current engagement activities with UK listed companies and designed to address obstacles of engagement. Additionally, as suggested in the article, shareholders could shape the activities of the council to facilitate transparency, accountability, and follow-through of issues raised by institutional investors.

2 Tomorrow's Company, March 2010. *Tomorrow's corporate governance: Bridging the UK engagement gap through Swedish-style nomination committees*

3 C. Lawton, 2009. *A Proposal Regarding Shareholder Engagement in the UK*, International Corporate Governance Network (ICGN) Yearbook 2009

Incentives

While collective engagement can address a number of obstacles of stewardship, we note that beyond the scope of a stewardship code are important carrots and sticks that may significantly advance shareholders' ability to better resource its stewardship activities.

We note however that a compelling incentive for stewardship by institutional investors is demand by their clients for the same.

In promoting transparency and accountability (as the Principles advocate), a stewardship code would provide tools to enable clients to better articulate their demand, by being able to compare and assess managers' stewardship policies and practices as well as the results delivered by stewardship activities.

As such, we look forward to the establishment of a stewardship code that clearly articulates the scope and objectives of stewardship, provides international leadership regarding best practices recommendations on institutional investors' stewardship activities, the internal organisation of its stewardship activities, and collective engagement.

We hope that you find these comments helpful and would be happy to discuss any of these matters further.

Yours sincerely,

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A Proposal Regarding Shareholder Engagement in the UK

Catherine Lawton, Nestor Advisors Ltd



Many believe that the UK's 'comply or explain' model is the Rolls Royce of corporate governance regimes. Yet, there is considerable unease about one perceived flaw, namely responsible stewardship by institutional owners. This deficit is not to be left unattended.

As the UK's Financial Reporting Council states, "it is of critical importance [to the continuing credibility of the 'comply or explain' model] that there are sufficient institutional investors willing and able to engage actively with companies in which they invest".

The 114 responses to the FRC's call for evidence regarding the effectiveness of the UK's Combined Code on Corporate Governance and the 100 interviews conducted with board chairs of listed companies by the FRC indicate widespread support for retaining the UK's soft-law approach to governance. Market participants and the FRC nevertheless, clearly advocate the development of proposals that would "encourage both companies and investors to be more proactive about regular engagement and with a longer term focus" and do so in a manner that avoids prescription.

Reaching across the void

Currently, institutional investors engage with UK companies in four formats. Firstly, there is the investor roadshow, where typically the dialogue on the subjects of performance and strategy is between investment managers, a company's chief executive and its financial director. This appears to serve both parties well, although companies indicate that better preparation by shareholders would create a better output. Other critiques include the short-term focus of these roadshows and the absence of board chairs from these or subsequent one-on-one meetings, which could be valuable opportunities to deepen clients' understanding of investors' views.

Another setting, the annual general meeting, is considered by some as a necessary and appropriately democratic vehicle – albeit a highly politicised one. One criticism of the annual general meeting is that the format – including activities before, during and after – does not permit sufficient dialogue and debate of the matters upon which investors are asked to vote.

A third method is one-on-one conversations between investors and company representatives. The Code encourages discussions between institutional shareholders and the company, with the latter represented by executives, board chair and, when appropriate, the senior independent director and other directors. The Code recognises the annual general meeting as separate from the dialogue with institutional shareholders and underscores the importance of each. Observers and participants suggest that the economics of the investment industry and rent-seeking behaviours mean that these one-on-one discussions happen far less than they should. Informal, sporadic one-on-one meetings – when they do occur – offer the privacy that is needed for candour. However, that same quality – the ameliorative positioning of what is otherwise viewed as a lack of transparency – increases the probability that companies may not follow through on action items and facilitates companies' ability to 'divide-and-conquer' investor opposition.

Finally, a less common but sometimes-used method is collective meetings between a number of shareholders and company representatives, initiated by either investors or the company.

Desire and discontent

Responses to the FRC's call for evidence indicate that there have been many positive experiences with, as well as concerns regarding, the utility of engagement activities. Discussions with some board chairs identified a number of potential benefits of engagement, such as gaining a better understanding of investors' views on strategy as well as the quality of the management team.

Companies, however, expressed frustration with investors' lack of interest in, or preparedness for, dialogue regarding issues of governance as well as, in some cases, a single investment firm failing to coordinate the positions taken by different departments within its firm. Companies felt handcuffed by current arrangements whereby "the Code and Listing Rules obliged them to attempt to engage with investors who were under no obligation to reciprocate". For example, the Code "encourages non-executive directors to meet major shareholders ... when there appear[s] to be little demand on the part of shareholders for such contact".

Companies are in turn criticised by investors for having a tendency towards boilerplate reporting of compliance with

the Code, and failing to communicate the extent to which they act upon engagement messages from investors. Some board chairs are said to fail to embrace their role as large shareholders' principal point of contact on governance and meet at least annually with a significant proportion of a company's largest shareholders. There is additional concern that executives and chairs fail to provide non-executives with feedback of shareholders' views.

An engagement proposal

While there are a number of potential policy tools beyond the Code that may incentivise greater shareholder oversight, we believe the Code can further promote more effective shareholder engagement by recommending that companies host multilateral meetings with its largest, long-term shareholders not on an ad hoc basis, but at least once per year. The Code could recommend that attendees include, if not the entire board, then at least the board chair, senior independent director and non-executive directors with key positions on board committees.

Complementing the discrete one-on-one meetings already held, these shareholder council meetings would serve as a venue for shareholders to express views to not only the chair and non-executive directors but also to their investor peers. The Code could recommend that these meetings focus on governance and other long-term and strategic issues, so as to complement the short-term focus of discussions surrounding earnings reports. The Code may suggest that the shareholder council be of a size to facilitate discussion and that members be determined in a transparent and, if not democratic, then fair manner. For example, membership may be determined by a vote of shareholders or selection of the largest shareholders on record date who were owners of shares in the company for a stated period.

Ideally, these shareholder council meetings would be open to observation by all shareholders, with the right to participation limited to the major shareholders. This would create a transparency that may strengthen follow-through on an action item, particularly if companies chose to publish the meeting's agenda and updates on matters being or to be addressed. Limiting participation to major shareholders may better bring to the fore the talents of professional shareholders than annual general meetings currently allow.

The transparency of these meetings would benefit both institutional shareholders and companies. Should a member of a shareholder council not attend or adequately discharge responsibilities associated with the role, a company would be in a position to demonstrate that its attempts to engage with the shareholder were thwarted by the investor. Strategically-minded marketing personnel of competing investment firms may use this information for their own advancement in positioning itself with desired clients.

Board chairs could be encouraged to derive the agenda for shareholder council meetings from priorities expressed by council members, and communicate briefly to all shareholders the rationale behind the selection of agenda items. Additionally, chairs that facilitate an interactive dialogue – rather than manage a series of formal announcements or communication of positions – would better provide shareholders with valuable insight regarding the functioning of the board, its group dynamic and perhaps also the abilities of board members, on whose directorship the shareholder would then be in a better position to opine.

There would undoubtedly be issues to tackle so as to implement this proposal, such as identifying or selecting investors to serve on the council, and the changing composition of the council. The declining ownership of UK equities by UK insurance companies and pension funds – with the latter at roughly 13% – is said to impede engagement and may require further creative thinking so as to bring a shareholder council into being. However, these issues can be addressed: indeed, they are already being addressed in other jurisdictions. The shareholder council would not work in isolation but would complement other forms of engagement and be well supported by carrots and sticks that emanate from sources other than the Code.

While certainly not a panacea, these shareholder council meetings – by promoting transparency and follow-through, encouraging chairs to meet at least once per year with major shareholders, directly exposing non-executive directors to shareholders' views, and giving shareholders an opportunity to observe non-executives directors – may go a long way towards more effectively promoting a mutual understanding of objectives, enabling investors to make considered use of their votes and providing investors with sufficient information to make reasoned judgements, if not better investment decisions.