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Consultation on a Stewardship Code for Institutional Investors

The voice of responsible shareowners

We welcome the opportunity to respond to the consultation on the proposed Stewardship Code for Institutional Investors. Pensions & Investment Research Consultants Ltd (PIRC) has been an independent adviser to pension funds and other institutional investors for over 20 years. PIRC's clients have combined assets in excess of £1.5 trillion and include some of the largest pension funds, investment management companies and insurance companies in the UK and overseas. We have been involved in shareholder engagement – or stewardship – from the outset and have undertaken this activity both on behalf of clients and in our own right. Our comments are based on two decades of practical experience in this field.

GENERAL COMMENTS

Background to the Stewardship Code

PIRC believes that it is critically important to reflect on why a Stewardship Code has been proposed at all. There are, in our opinion, two principal interlocking factors. First, the proposed Code is in part a response to the biggest financial disruption for decades. It is a part – though only a part – of the general post-crisis reform effort. It is therefore intended to mitigate future crises. Second, there is a widespread perception that institutional shareholders have failed in recent history to exercise the kind of oversight that was expected of them both in theory and by their clients. Therefore by seeking to codify what can be expected of them in future, the proposition is that institutional shareholders can be held accountable for their ownership activity.

Taken together both these factors suggest that engagement, or stewardship, is activity that institutional shareholders should generally be expected to undertaken, and which will strengthen the financial system. These assumptions may be challengeable, but they seem to use to be the bedrock on which the Code is based. In addition these assumptions sit well with the pre-existing approach to governance in the UK. This has generally focused on the need for companies to be accountable to shareholders, and has seen the gradual enactment of various different shareholder rights. These rights in turn can be reasonably characterised as being based on the idea of shareholders as owners of companies.

We believe that this very brief summary is an accurate description of the genesis of the Stewardship Code. We may have a different perspective on some of the underlying assumptions, but we accept that it is a coherent approach. But if this approach is accepted then it will only be effective if the importance of the role accorded to shareholders is absolutely clear. If shareholder oversight is to be one of the mechanisms intended to mitigate future crises, and if the shareholder role as 'owner' is to be further codified, this must be given serious weight.

Given the role – and rights – afforded to shareholders it must surely be open to question why any sizeable asset manager should require the beneficial owner that employs them to mandate them to act like an owner, as suggested in para 1.3 of the consultation document. If shareholder oversight is intended to have a quasi-regulatory function then it is not clear why major institutional investors should require clients to tell them to undertake this role.

We also have grave doubts about the likely success of any voluntary and/or self-regulatory approach to these questions. We therefore urge the FRC to be aware at all times of the dangers – both for practical implementation and for effective policy outcomes – of relying on investment industry initiatives and structures. These have proven in recent times to be woefully inadequate. The consultation document refers to the issue of voting disclosure in para 2.11. PIRC believes this is an important example of the failure of self-regulation, and we set out our view on the serious flaws in the 'comply or explain' approach to this issue discuss later in our response.

Finally, there will of course be investors which do not choose to sign up to any Code in relation to ownership activities. This is a reasonable stance if their strategy is purely a trading one. But again, in light of the underlying assumptions behind this initiative, this may call into question why such investors are granted any formal rights of ownership. We note that both Lord Myners and leading US governance expert Bob Monks have questioned whether voting rights, for example, need be awarded to short-term investors. PIRC would be open to proposals on how ownership rights could be dependent on length of investment. We believe that the FRC may wish to explore this issue further in future.

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RESPONSES TO SPECIFIC ISSUES

Consultation questions

The FRC is seeking views on whether it should accept oversight of the Code in its current form, or whether amendments should be made before the FRC does so.

We believe that all references to the ISC should be removed from the Code, and it should be solely described as the Stewardship Code. As a body the ISC is neither representative of all institutional shareholders, nor of all those with an interest in the ownership of the UK's public companies. It is first and foremost a collective of trade bodies. In addition it has demonstrably failed to show leadership both pre and post-crisis, and in our opinion does not command respect within the institutional investor community.

We make further comments on the content of the Code below. We believe that Principle 6 and the associated guidance should be rewritten.

Views are also sought on which institutional investors and agents should be encouraged to apply the code on a "comply or explain" basis, what they should be asked to disclose and to whom, and the monitoring arrangements that should be put in place.

As set out above, based on the experience of a 'comply or explain' approach to voting disclosure, discussed further below, we have doubts about the investment industry's ability to make such a system work effectively. In addition we would question, given the quasi-regulatory role seemingly envisaged for shareholder oversight, why large institutional investors should be able to 'explain' non-compliance with the Code. It may be simpler to make adherence to and reporting in line with the Code mandatory for investors of a given size.

The FRC would encourage all UK institutional investors to apply and report on the Code regardless of whether or not they are subject to mandatory requirements, and would welcome views on whether there are any barriers or other reasons that would prevent or discourage them from doing so.

As highlighted above, given the emphasis put on the role of shareholder oversight we see know reason why the FRC should not expect institutional investors to apply and report on the Code. We note that many institutional investors already report on application of other principles, such as UNPRI.

We would encourage the FRC to consider the impact of one technical barrier to application, which may result in disenfranchising beneficial owners. Certain pooled funds do not allow clients to exercise pro rata voting instructions. This means that the asset owners whose assets are held within such vehicles are unable to vote all their shares in accordance with their wishes and may have to wait some time to find out their notional exposure was voted. This certainly restricts meaningful involvement on the part of end-clients. We consider that it should be a best practice requirement for such pooled funds to enable voting decisions to be made by the underlying asset owners and reflected in the votes cast.

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.

As the FRC is aware, PIRC has recently drafted a set of best practice principles that we seek to adhere to, and which we believe could apply to others in our sector. We believe that these principles address more relevant issues for those firms which primarily focus on voting than the Code as it stands.

That said, PIRC also has a well-established shareholder engagement service which we believe could be covered by the Code (excepting references to investment decisions and strategy which are not relevant). We have no objection in principle to adhering to, and reporting in line with, the Code in respect of this aspect of PIRC's activities and see no barriers to doing so.

What are the responsibilities for engagement of institutional investors to the beneficial owners whose interests they represent? Does the ISC Code cover all the relevant responsibilities?

As we state earlier, we do not believe that institutional investors require a mandate from beneficial owners in order to undertake engagement activity. Asset managers should consider that this is core part of their service to clients, regardless of whether they have been specifically requested to be alert to issues of ownership.

Indeed, we would argue that institutional investors might consider that most end investors (ie pension scheme members and other beneficiaries) actually have a long-term interest in the success of investee companies. In the case of pension funds, asset managers are investing on behalf of collective investment vehicles that can expect to be in existence for decades to come. Therefore PIRC believes that institutional investors should be encouraged to approach engagement with a long-term perspective in mind.

The Code as it stands is broadly acceptable, and covers all the principal areas of responsibility in respect of stewardship, though we believe the FRC could consider whether there should be more emphasis on responsibilities to investee companies. In addition there are specific areas where we believe further clarification may be required. We detail these areas further below.

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?

PIRC believes that this is a vitally important issue. Understandably, given the factors that led to its development, the ISC Code seems primarily focused on the responsibilities of investors as the effect beneficiaries. Most of the Code is dedicated to formalising the type of policies that should be in place, the activity that will flow from them, and how this is reported to clients and the wider public. Although there is discussion of the interaction with companies, this is primarily framed in terms of formalising such activity, recording it and reporting it. The message in primarily one of codifying what investors will do *to* companies.

This is entirely reasonable, but we believe that it should perhaps be balanced by an accompanying codification of what companies can expect *from* investors. In our own set of best practice principles, for example, PIRC highlighted the need to provide companies with copies of governance and/or voting guidelines that frame ownership activity. We also set out the importance of giving companies a 'right to reply' on analysis undertaken of their governance arrangements and resulting voting recommendations.

As such we believe that the FRC could consider adding a further principle to the Code which states that investors will have clear policies in place for communicating to companies and offering the opportunity to reply. The associated guidance could set out our more detail of what companies might reasonably expect.

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

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It may be helpful to provide guidance on how different types of institutional investors should relate to the Code. For example, if a pension fund delegates responsibility for engagement to appointed fund managers, then it seems reasonable that the responsibility for disclosure in line with the Code applies to those managers, not the fund. But where a pension fund has alternative arrangements in place – such as employing in-house staff to work on such issues – the fund should apply the Code itself.

In addition consideration should be given to how the Code should apply to collaborative groups of investors. There is a small but growing group of voting and engagement alliances emerging in the UK. The FRC may wish to consider whether members of such groupings could make a collective disclosure on compliance with the Code, and whether this should be instead of or in addition to individual disclosures.

Does the Code strike the right balance between the need to avoid overspecification that might discourage the application of the Code and the need for it to be effective with an appropriate degree of transparency?

We believe that at present the most pressing concern is to have a Code in place and begin to monitor what impact it has. It is impossible to ascertain in advance what the outcomes will be and therefore whether the Code as it stands is too specific.

In addition, PIRC's view is that – in common with the application of the Corporate Governance Code – investors could indicate where they comply and where not. As such we are broadly happy with the Code as it stands an believe the emphasis should be entirely on implementation, with revisions in future as necessary.

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

Principle 6 should be strengthened to read as follows.

"Institutional investors should have a clear policy on voting ***and publicly disclose their full voting records***."

The current approach to voting disclosure in the UK is fundamentally flawed and does not work in the interests of beneficiaries. It is extremely important that the FRC does not take the investment industry's lobbying and claims on this issue at face value.

PIRC is a long-standing advocate of mandatory voting disclosure, and, alone amongst voting advisers, makes it own voting recommendations publicly available. Since this issue first came to prominence in the early 2000s, the industry has had to be dragged kicking and screaming to accept the principle that public disclosure is a good thing. The ISC only formally endorsed this position – after much pressure from the Government – in 2007, and did so in the weakest terms.

The headline statistics quoted by the investment industry are misleading on two counts. First, the growth in transparency amongst asset managers has not been driven by the industry itself. In our opinion it has been driven far more by external pressures such as campaigning by the TUC and others and, probably most importantly, the Government's decision to take a reserve power in the Companies Act. It should be noted that even during the passage of the Companies Act members of the ISC were lobbying to have the reserve power removed.

Second, the headline statistics disguise a wide variety of reporting methods and schedules. For example, some managers appear to update their disclosures annually, others quarterly, others monthly. But more importantly the different types of disclosure make the headline statistics meaningless. Some asset managers only provide headline stats themselves (ie % of votes for and against in a given year) whereas others provide a full voting record. Some managers only disclose votes against and abstentions which inevitably makes them appear more likely to use their legal rights to challenge management than they actually are. Arguably this is analogous to only disclosing trades

which generated a positive return. It provides a fundamentally skewed picture of activity.

However the fatal flaw in the ‘comply or explain’ approach to this issue is the failure of almost all asset managers who do not disclose voting decisions to explain their policy. To date PIRC has only been able to find one asset manager that provides a brief explanation. We urge the FRC to carry out a brief review of fund manager websites to reach its own conclusion on the effectiveness of a ‘comply or explain’ regime in this area.

Principle 6 should state that investors should disclose their voting, not their policy on disclosure (since such an approach has clearly failed). The associated guidance should instead set out that investors should disclose their full voting record – all votes on all resolutions at all companies. If the FRC adopted the principle as it stands it would merely serve to reinforce a flawed system.

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

As stated above, we would encourage the FRC to consider whether to introduce a principle addressing communications with investee companies.

The FRC would welcome views on:

• The information that institutional shareholders should disclose publicly and that they should report to clients;

As highlighted above, we believe it is important that the FRC revises Principle 6 to instruct those adhering to the Code to publicly disclose their full voting record. We also believe it would be helpful if those institutions seeking to be compliant with the Code produced an annual report on implementation that was made publicly available.

In addition we believe that all institutional investors that undertake ownership activity themselves (ie voting and engagement) should be required to produce a public report detailing what activity was undertaken in respect of the UK-listed banks. As it stands there is still very little publicly available information on what activity was undertaken. Publication of such a document would greatly aid understanding of what went wrong, and how institutional shareholders could improve in future.

In respect of reporting to clients, most asset managers already produce quarterly reports and in many cases these include some details of voting and engagement activity. PIRC itself produces quarterly reports for clients on governance and social responsibility issues (an example is included for information).

We see no reason why those complying with the Code should not produce a report at least quarterly on voting and engagement activity undertaken for clients.

• The arrangements that should be put in place to monitor how institutional shareholders apply and report against the Code;

We see no alternative to the FRC undertaking this role, or, if there are resource constraints, appointing a third party to carry this out. In the longer term it may be that a combination of public and client interest lead to analysis being carried out by investment consulting firms, or those who have taken an interest in this area like the TUC and Fair Pensions. But there must be some ‘official’ monitoring undertaken, or the Code will lack bite.

• The arrangements for reviewing the operation and content of the Code.

We envisage the FRC undertaking periodical reviews comparable to those undertaken in respect of the Combined Code. We urge that the FRC have sole responsibility for

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this, as we do not have faith in the ability of trade bodies to undertake such work with an objective perspective.

The FRC would welcome views on the specific information that should be disclosed by institutional shareholders and their agents, and at what level of detail the "comply or explain" principle should apply.

PIRC believes that investors should generally apply the Code in its entirety, since many of the activities and policies are inextricably linked. In this sense it is not directly comparable to the Corporate Governance Code, where companies might comply barring one or two exceptions.

Investors that adhere to the Stewardship Code ought to be able to make an annual disclosure in which they set out how they applied each principle, with links to relevant other documents or disclosures – like voting records – where necessary. We believe that the FRC should encourage some degree of standardisation in these disclosures, as our experience to date is that can be a wide variety in content and frequency of reporting of this type at present.

PIRC also believes that there should be an emphasis on both quantitative and qualitative disclosures in respect of the Code. Investors should be encouraged to provide both comparable data – including a full voting record – and examples of activity undertaken. Obviously there will be concerns about confidentiality, but we believe that real-life examples which can be verified are much more important than disclosure of policies.

Views are invited on the structure of the ISC Code and on the best way to encourage reporting against it on a "comply or explain" basis.

PIRC believes that the best way to ensure that a reasonable depth of reporting is carry out by investors is by ensuring that an effective monitoring regime is in place. Again we would draw the FRC's attention to the failure of 'comply or explain' in relation to voting disclosure. This is in no small part due to the fact that the industry itself was given the task of assessing progress. The result has been shambolic, with apparently no pressure on the many investors who do not 'explain' their non-compliance.

Therefore it is vital that the FRC makes clear from the outset that it will monitor disclosures, and takes the implementation of the Code seriously.

Views are invited on the proposals in ISC Code for reporting to clients and the merits of independent opinions from auditors or other professional accountants. It would be helpful to have estimates of the costs incurred by asset managers in commissioning these opinions and of the benefits to asset owners.

We believe that in the short term independent opinions on reporting from auditors or accountants would add little value and would simply incur expense. This is new territory for some institutional investors, let alone other professional services firms. We do not believe that there exists the knowledge and experience within the accounting industry at present to add any value in this area.

However, there are a small number of investment consultants who might be able to provide a critical overview of the reporting provided.

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

We believe that the IMA survey is an interesting and useful piece of regular research. Nonetheless it inevitably has developed in a way that has sought to showcase good practice on the part of its members, rather than providing an objective overview. It is worth reflecting on the fact that the IMA only originally instigated the engagement survey once the TUC had announced its decision to research fund manager voting

decisions. In addition we believe that the IMA, understandably, puts a very positive spin on the voluntary approach to voting disclosure. As an organisation which both discloses it votes and has researched the disclosures of others, our experience of the system is rather different to the picture usually painted.

We believe a survey similar to the IMA's could be useful for monitoring application of the Code, but would not suggest adopting in its current form. We would also encourage the FRC to talk to the TUC about its experience of researching fund manager voting and engagement, which inevitably will provide a different perspective.

Views are invited on the proposed approach to reviewing the Code.

We agree that an approach to reviewing the Code equivalent to that applied to the Corporate Governance Code is appropriate. However we would urge that the FRC undertakes the first review after one year, as there will almost certainly be areas that require revision. In addition PIRC believes it is vital that some analysis is undertaken of individual investor disclosures. We would rather that the FRC undertook this, or appointed a third party to do so. Otherwise there will be no real oversight - a point acknowledged by Sir David Walker in his review last year.

Further information

PIRC would be happy to discuss the points we have made in our submission in more detail. Please contact:

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