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Dear Susannah

### **FRC CONSULTATION ON A STEWARDSHIP CODE FOR INSTITUTIONAL INVESTORS**

I am writing to comment on the above consultation paper on behalf of rpm and Railpen Investments, the investment monitoring arm of the Railways Pension Trustee Company Limited, the corporate trustee of the UK railway pension funds with approximately £18 billion of assets under management and 350,000 beneficiaries.

We are long standing supporters of better corporate governance as one of the first UK occupational pension funds to introduce active voting for all our UK equity holdings in the early 1990s, and welcome the opportunity to participate in this latest consultation as a major asset owner whose investment arrangements are outsourced to external investment managers. It follows that we have a strong interest in effective stewardship as an end client and a responsible investor.

We feel that a key benefit of the proposed Code will be to provide a formal structure to enhance the ability of asset owners to hold their asset managers to account on stewardship. This is consistent with the Myners Principles for investment decision making and in particular with Principle 5 in the revised 2008 version which encourages pension fund trustees to hold their asset managers accountable and explicitly refers to the earlier ISC principles on the responsibilities of shareholders and their agents.

Our overall impression is that the proposed Code provides a useful framework that addresses many of the key elements of effective stewardship. We strongly agree with the FRC that the Code can contribute to a sadly still needed but also significant improvement in the stewardship of UK listed companies, and that the potential benefits are large, provided that it is applied effectively and consistently by a critical mass of institutional investors. However, the challenge for the FRC and the wider investment community including asset owners will be to translate the Code's principles into a functioning system that provides more effective support for the parallel Combined Code for companies without imposing too great a regulatory burden on both investors and investee companies.

We were consulted in the drafting of the responses prepared by the ICGN and the NAPF and while in broad agreement with them on many issues, we would like to add our own specific comments below:

*Our vision is to be the provider of choice for pension services.*

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## **ISSUES FOR COMMENT**

### **Section 1: Introduction**

#### **Policy Objectives**

We welcome the involvement of the FRC in the oversight of the Stewardship Code. The FRC already has a major role in promoting good practice in both financial reporting and corporate governance through the work of the Financial Reporting Review Panel and FRC's existing oversight of the Combined Code. It is both consistent and appropriate for the FRC to extend its remit to cover the Stewardship Code. We agree with the NAPF's observation that as a result pension funds stand to gain from standards that are set independently of asset managers and will assist asset owners in holding their intermediaries to account.

We support the general thrust of the policy objectives but have some reservations about the form and to a lesser extent the substance.

A number of terms are used interchangeably in the section on policy objectives and elsewhere in the consultation paper and would benefit from greater consistency. These include "institutional investors" and "shareholders", "institutional shareholders" and "mainstream institutional investors". It would be preferable in our view to use "institutional investor" throughout the text to avoid unintended ambiguity. We think it might also be helpful to attempt define various other key terms such as "engagement" and "stewardship" as well as the different parts of the investment chain to ensure greater clarity.

We feel that the objectives would benefit from both clarification and simplification, and suggest the following for your consideration:

- Promote awareness and encourage adoption of the Stewardship Code by both UK and non-UK institutional investors
- Improve dialogue between companies and their investors and also between institutional investor agents and their clients
- Ensure that engagement is integrated effectively into the investment process, beginning with security selection, continuing through investment monitoring and annual voting
- Encourage collective engagement with a view to protecting shareholders' capital from permanent impairments, aligning agency interests (including those of executive management) and enhancing long-term sustainable value
- Develop transparent and effective means of monitoring and reporting on the application of the Code by institutional investors

#### **Should the FRC accept oversight of the Code in its current form?**

As stated above, we agree that the FRC should accept oversight of the Code but have some further comments below on suggested changes to the ISC document that we set out in greater detail in section 4 on the content of the Code. We feel that the ISC document is a useful starting point but could still benefit significantly from improvements in structure, definition and content.

## **Which institutional investors and agents should be encouraged to apply the Code on a comply or explain basis etc?**

The Code should be applied, as appropriate, by all in the investment chain, including proxy agents and investment consultants, on a comply or explain basis. However, given that pension funds delegate much of the engagement to their intermediaries, the burden will fall mainly on asset managers, although asset owners would still have the duty to hold them to account.

There may be a case for a minimum threshold to ensure economies of scale as smaller investment houses and pension funds do not necessarily have the resources to undertake stewardship to the fullest extent. However, smaller investors who sign up for the Code should be welcomed, and size of itself should not deter pension funds from probing their asset managers and other intermediaries on the application of the Code. It follows that we agree with the Code's proposal that asset owners should specify in their mandates the policy on stewardship to be followed.

We also feel that non-UK investors should also be encouraged to apply the Code but recognise that it may be necessary to use a different approach to achieve this which recognises that participation is voluntary. We note that some major overseas pension funds have already indicated publicly that they intend in principle to endorse the Code which we welcome. Given the globalisation of management and ownership interests within many fund management firms, we believe further buy-in should be taken up with trade associations, governments and other influential bodies, as well as the firms themselves, starting with their UK head offices.

## **Section 2: Background and Recent Developments**

### **Insights on lessons which may be learned from experience outside the UK**

Overseas investors are probably better placed to advise on the full implications of developments in their own markets. However, we are a cross-border investor with significant overseas exposure and have many contacts in other markets. We also participate in various international, regional and country-based investor trade bodies and governance groups that have given us some insight into overseas practices on stewardship.

It is certainly true to suggest that good practice can be found outside the UK and we draw particular attention to Australia and the Netherlands where local investor bodies, such as the Australian Council of Superannuation Investors (ACSI) and Eumedion, have promoted collective engagement with tangibly positive results.

Membership of Eumedion has been open to non-domestic investors for some time. ACSI, by contrast, used to restrict membership to Australian pension funds but recently extended eligibility to non-domestic pension funds. Railpen became the first overseas member as ACSI recognised that it needed to reach out to like-minded foreign investors. However, ACSI, despite relaxing its earlier requirement on domicile, has nevertheless retained its strong policy of confining membership to asset owners in order to reduce conflicts of interest and to buttress its independence.

Although the UK is the first market to move towards introducing an investor stewardship code, we are aware that there are early stage initiatives underway in other markets including France, Holland and South Africa. Although in principle we welcome the promotion of better standards in all markets, there is an obvious risk that the proliferation of codes could cause confusion and create compliance challenges particularly if requirements differ significantly. The FRC will need to use its contacts in the broader international regulatory community to ensure that this risk is recognised early, and mitigated.

### **Section 3: The Coverage of the Code**

**Should the FRC encourage all UK investors to apply and report on the Code? What barriers are there, if any, to prevent or discourage UK institutional investors applying and reporting on the Code (regardless of any mandatory requirements)?**

Please see our response in section 1 above in which we state our view that the Code should be applied, as appropriate, by all in the investment chain, including proxy agents and investment consultants, on a comply or explain basis. However, we recognise that there are some barriers both in perception and in practice.

We have already mentioned size and that smaller funds and managers may feel that they have insufficient influence to make a difference. A significant barrier to applying and reporting on the Code may be related to this. For entirely rational economic reasons many investment management firms have obtained returns for their clients by trading or even shorting shares rather than from carrying out ongoing stewardship activities. It will be a step change for many to assume these additional responsibilities and this may explain some degree of reticence.

A further factor may be client pressure, or lack of it. It could be argued that investment management agreements between fund managers and their clients do not always reflect sufficiently the issues which concern long term sustainable value including the need to conduct engagement and voting activity, and to report on it.

In this context, we feel that pension funds and other asset owners should take the opportunity provided by the introduction of the Code to consider how the managers that they appoint carry out and report on this activity. In this regard, we welcome the NAPF's recent initiative in February in publishing early stage guidance, "ISC Code - First Steps" to assist pension schemes. This is inevitably preliminary in nature because the Code has still to be finalised but is helpful in making clear to trustees that there will soon be a Stewardship Code and that funds need to be prepared by asking the right questions and formulating appropriate policies.

We would also note that certain pooled funds do not allow clients to issue 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 how their proportionate exposure was voted. This certainly restricts meaningful involvement and engagement on the part of end-clients. It can be a significant barrier to effective stewardship. We consider that it should be a best practice requirement, on a comply or explain basis, for such pooled funds to enable voting decisions to be made by the underlying asset owners and reflected in the votes cast. We feel that pooled funds should be encouraged to facilitate pro rata voting and to explain publicly if and why they do not.

**Should agents such as voting services agencies and investment consultants be encouraged to commit to the spirit of the Code and how could this be done?**

We believe that voting agencies and investment consultants should be encouraged to commit to the spirit of the Code as they contribute significantly to effective stewardship.

Proxy research providers and investment consultants should comply or explain and should disclose their commitment to the Code in a separate category so that their roles as intermediaries are understood. Their commitment to the spirit of the Code can be facilitated by encouraging more transparency among the proxy agencies on matters such as policy formation and a retrospective analysis of policy application. We would refer you to the recent set of best practice principles for proxy advisory firms published in February 2010 by the UK-based Pensions and Investments Research Consultants (PIRC) in response to the Stewardship debate, which we commend. We hope this kick-starts a debate about the accountability of such firms. Some sort of requirement for all proxy advisory firms to publish their own set of best practice guidelines or be required to adhere to an industry standard would be helpful in this area.

However it needs to be emphasised that the role of voting agencies does not generally extend beyond the engagement necessary to provide good quality voting advice. Some proxy advisory firms have a disproportionate influence, which some investors hope will be limited as a consequence of the Stewardship Code - given that asset managers as intermediaries will be required to take their voting and stewardship responsibilities more seriously and not just outsource it passively to proxy advisory firms. This can be a hindrance to dialogue between companies and shareholders, and limiting the power and influence of such firms is a real challenge to the investment management industry. We accept, however, that some investment managers, following so-called "quant" strategies, may not engage or even meet with management of potential investee and existing investee companies. Even these firms should take a stronger line on voting when they appoint advisory agents to vote on their behalf.

It is a statement of the obvious that investment consultants often effectively set the agenda for many trustee meetings and advise on manager selection and termination. If the consultants do not incorporate stewardship concepts into their responsibilities, there is a real danger that there will be limited substance to any take-up of the Code by pension funds. It follows that consultants will play a critical role in making the Code effective if it does not just become an empty formality, a cost with little or no benefit to scheme beneficiaries. We therefore welcome the NAPF's observation that there is evidence that investment consultants are improving their coverage of stewardship matters, partly in response to client demand.

**Cross border conflicts arising from the application of the Code**

**Would foreign investors be willing voluntarily to commit to a Code sponsored by a UK regulator such as the FRC or a UK industry body like the ISC in respect of their holdings in UK companies?**

This is better answered by foreign investors. However, as we observe above, some major overseas public pension funds have already publicly indicated that they will give this serious consideration. Other asset owners, including a leading sovereign wealth fund, are also understood to be considering it privately. From our preliminary enquiries of our own non-UK external fund managers, the position is less clear and some are only just beginning to comprehend the implications. We commented earlier above about the possibility of contacting the UK representative offices of overseas firms, and also their trade associations.

However, given that foreign ownership of UK equities reached 41% of the total at the end of 2008 according to the UK Office for National Statistics, it is axiomatic that overseas investors have a major potential role in better stewardship and need to be encouraged strongly to take it very seriously.

We agree that it is sensible not to discourage foreign investors by imposing the same regulatory requirement to comply or explain that the FSA is expected to consult on for UK-authorized firms later this year.

**What is their current practice on disclosing information on their engagement policy, including any national or international standards they follow?**

We are a global asset owner retaining multiple UK and non-UK external fund managers across many markets and are in a position to observe this. Not surprisingly it varies considerably according to market and size.

**What are the barriers or other potential difficulties for foreign shareholders seeking to engage with UK companies?**

We speak from a domestic UK perspective but believe that the legal barriers are likely to be minor. However, the UK is a relatively small market for many foreign investors in terms of the percentage of their invested assets. For this reason, it is likely that domestic institutional investors will continue to assume the leading role in upholding the Stewardship Code. Some foreign investors welcome collective engagement but others are more wary.

**What are the potential conflicts that might arise for investors operating on a cross-border basis between requirements or codes in place in other countries and the proposed Code?**

We do not claim great knowledge in this area but would observe that rules concerning concert parties may be stricter in some jurisdictions than in the UK which may serve as a deterrent to some overseas investors.

As noted above in our response to section 2, the proliferation of codes could cause confusion and create compliance challenges. Greater international regulatory co-operation may help to reduce this risk. The UK Stewardship Code is likely to be one of the first national codes of its type in the world and may serve as some kind of reference document for other jurisdictions which underlines the importance of ensuring that it is fit for purpose from the outset.

**Section 4: The content of the Code**

**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?**

It is not entirely clear whether the term "institutional investors" in this context refers to asset managers in relation to their clients or asset owners, such as pension fund trustees, in relation to their own beneficiaries. This underlines the need for the Code to be clearer about different parts of the investment chain, as there are significant nuances.

The fiduciary duty of the fund manager is to the asset owner who in turn owes a fiduciary duty to the underlying beneficiary of the assets. For pension funds much depends on the mandate which is agreed between the trustees and their investment managers. In strict legal terms, the trustees are the beneficial owners of pension fund assets rather than the scheme member beneficiaries. However, we believe it is reasonable to expect pension funds to report to their members on how the trustees have overseen any engagement responsibilities which they have delegated to their investment managers. This is reinforced by the requirements of Myners Principle 5 on responsible investment.

**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?**

It may be helpful to recognise that engagement comes in different forms, from considered voting through to activism. Each variant is a legitimate means of protecting clients' interests.

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

No, not as it stands. In our view, the proposed Stewardship Code does not provide sufficient clarity on the respective responsibilities of the different parties in the investment chain, particularly between asset owners and asset managers. The Code would benefit from greater differentiation between the responsibilities of pension funds and other "owners" as against those of the investment managers and the advisory firms. There is considerable overlap inevitably and some funds for example would be classed as both owners and investment managers. As pension funds typically diversify their investments, individual funds are unlikely to have significant equity interests in any one company. Greater equity interests are likely to be seen at fund investment manager level, aggregating the interests of different clients where possible.

The Code does not state, beyond a very brief reference in its introduction, whether, as a principle or as guidance, the fiduciary duty of the fund manager is to the asset owner client who in turn owes a fiduciary duty to the underlying beneficiaries of the assets. This needs to be reiterated more explicitly on the face of the Code.

**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?**

We recognise that too onerous a Code will deter some foreign investors from adopting it and may encourage some UK investors to "explain" that the Code is not relevant to them. However, we strongly feel that the approach should not be to seek the lowest common denominator. If the standards are too broadly defined or are too weak then the Stewardship Code will be ineffective and will do little or nothing to improve engagement.

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

In terms of substantive amendments, we make the following suggestions on the existing Stewardship Code provisions:

#### **General**

It would be helpful if the Code introduced its purpose and what it aims to achieve in order to put it into overall context.

## **Principle 1 – Public Disclosure of Stewardship Policy**

The guidance makes no direct reference to collective engagement although it is covered in principle 5 later on. This should be tidied up with a mention in Principle 1. It would also be helpful to require disclosure of the policies on securities lending and recalling stock on loan.

## **Principle 2 – Conflicts of Interest**

The guidance could be improved further by calling for disclosure of all material conflicts and a more explicit requirement that institutional investors and their agents should seek to mitigate such conflicts.

## **Principle 4 – Establish clear guidelines on escalation**

The clarity provided in the earlier 2007 ISC principles on the scope of the framework (the previous illustrative list of engagement issues covered) has been diluted and made vaguer in Principle 4 and should be added back for clarity. We also feel that risk issues should extend well beyond social and environmental issues to cover all material risks.

## **Principle 6 – Clear policy on voting and voting disclosure**

Voting is only a step in the wider process of engagement, and often occurs towards the end of the first period of ownership, and we feel that Principle 6 should cover both voting and engagement, which can often begin much earlier, even before investment is made.

We reiterate our earlier comment on pro rata voting in Section 3 above. We consider that it should be a best practice requirement on a comply or explain basis for such pooled funds to enable voting decisions to be made by the underlying asset owners and reflected in the votes cast. We feel that pooled funds should be encouraged to facilitate pro rata voting and to explain why they do not.

## **Does the ISC Code adequately covers the content of Section E of the Combined Code?**

Yes, but it is important that there is strong cross reference between the two documents.

## **Section 5: Reporting, Monitoring and Review**

### **What information should institutional shareholders disclose publicly and what information should they report to clients?**

Adequate reporting will be vital to the success of the Code and in ensuring that institutional investors discharge their stewardship responsibilities, whether investors choose to comply with the Code or explain why they do not.

Where investors choose to explain, they should discuss in some depth their approach to investment and why it is that stewardship does not form part of their fiduciary duty to their clients. We understand that the FSA intends to consult on a proposal to require UK authorised firms to state publicly on a comply or explain basis their position on the Code. We are likely to be supportive of such a proposal.

However, this will not necessarily discourage boilerplate disclosures. A suitably strengthened Principle 1 will provide a template for public disclosure which will extend to engagement. In respect of what should be reported to clients, this is strictly speaking a matter between the investment manager and its clients but we expect best practice will quickly evolve and will go beyond bare disclosure of voting.

From our own perspective as a pension fund that retains close to 20 external equities managers, we see significant differences in disclosure and reporting practices on the part of our intermediaries with room for improvement in some cases.

Hence we agree that it is important that some basic standards are set and welcome further discussion as the FRC collects views from the industry. We make the following initial suggestions:

- All institutional investors who claim to comply with the Code should be required to state, publicly and at a policy level, what is meant by compliance;
- Asset managers should publish on their websites an annual review of the application of that policy, which will include summary engagement and voting reports, consisting of policy exceptions and commentary on issues of particular interest.

In addition, we would encourage an emphasis on matters that would give insight into the quality of voting and engagement activities. Indicative topics that asset managers should discuss in detail could include:

- Resources allocated to voting and engagement activities, including the experience and expertise of dedicated voting and engagement staff and the involvement of fund managers and senior executives, if different;
- Key objectives and initiatives pursued during the period in question;
- Major developments and issues encountered during the period in question, including successful and unsuccessful interventions and explanation of differences in outcomes
- The extent to which voting and engagement activities have been integrated into the investment process and have impacted investment decisions in the main;
- The extent to which the level of resources allocated and activities undertaken meet client expectations as expressed in investment mandates.

The use of case studies would also be helpful and we acknowledge that these may have to be anonymised as we recognise that the details may have to remain confidential in order to sustain the trust between companies and investors. This information will assist asset owners and their investment consultants to assess how asset managers are discharging their stewardship duties.

We recognise that public disclosure of voting as distinct from disclosure to clients is unwelcome to some asset managers. The Government has reserve powers under the Companies Act to compel public disclosure of voting records and there is also a precedent in the USA for mandatory public disclosure. We note that there is now strong political pressure to implement this in the UK and it may well become a non-optional requirement.

### **What arrangements should be put in place to monitor how institutional shareholders apply and report against the Code?**

In the first instance clients and their investment consultants can be expected to monitor the performance of asset managers.

The regulatory authorities will also have a role in this. The FSA will ensure that authorised managers make the necessary public comply or explain disclosures but not to review the quality of the content.

We also consider that there is a role for external assurance to add further credibility and we comment below in more detail on the separate question on AAF 01/06 and the possible part to be played by the audit profession.

We believe that it should fall to the FRC to conduct some sort of general review of the quality of disclosure and reporting. The FRC already has some experience of this kind of role. Although not a precise analogy, the FRRP reviews samples of corporate narrative reporting and, as in the case of "Rising to the Challenge", publishes its general findings with an indication of areas for improvement. This could be usefully extended to institutional investor reporting. This would not preclude the use of a third party to conduct detailed research and the IMA survey, on which we comment in more detail separately below, is a possible example of how this might be effectively sub-contracted.

### **How should the content and operation of the Code be reviewed?**

We believe that the Code should be periodically reviewed by the FRC. It is probably sensible in the initial years to have an early review of the first full year of operation and thereafter less frequently unless needed urgently in the light of circumstances or particular aspects that may have emerged over time. It might also be sensible to consider reviewing the Stewardship Code in parallel or close to the review of the Combined Code given the importance of both documents as integral parts of the corporate governance regime.

We anticipate that some sort of review body will be established in due course. It is important to ensure that it includes representation from occupational pension funds to ensure that the voice of at least one of the end clients is heard. In view of the aspiration to encourage overseas investors to adopt the Code, it might be wise also to ensure some representation of non-UK investors.

### **What are your views on the ISC Code's proposals for reporting to clients and the merits of independent opinions from auditors or other professional accountants? (What are the cost/benefits of commissioning these opinions?)**

We believe that AAF 01/06 (and equivalent SAS 70 reports) could potentially provide assurance in relation to those parts of the Code that are capable of objective measurement, but further guidance from ICAEW is needed to do this. We are pleased to note that the ICAEW is taking steps to do so and will be discussing this further with the FRC in the very near future.

We support the introduction of assurance reporting based on the framework developed by the ICAEW. This framework is already being successfully applied to other aspects of fund management and recent meetings of some of the stakeholders (including representatives of the NAPF, IMA ABI and the major audit firms) have achieved a high level of consensus on those aspects of the Code that can be objectively measured and are thus capable of being assured, and those aspects that are too inherently subjective.

Useful features of such a framework include the existence already of the relevant standards, the ability to embrace international standards of assurance engagements so as to create some global reach, a form of reporting that goes beyond a yes/no binary approach, a timeline that is relatively short and light in cost. This approach is voluntary but has already shown that with investor pressure it can be effective in improving practice in key aspects of fund management.

We also suggest that such guidance should include provisions to enable the independent auditors to inform the FRC in the event of a serious misrepresentation by an institutional investor in respect of the Code or where there has been a major failure in controls over stewardship activities. This will provide the FRC with essential intelligence in serious cases and provide useful warnings of any inherent problems.

**What are the merits of the current IMA survey and other possible approaches to monitoring the overall application of the Code?**

We feel that the IMA survey is helpful in providing an overview of engagement and stewardship activities with an indication of broader trends. We hope that the FRC will encourage its continuance and takes the findings into account in its own deliberations. As we mention above in our response on the arrangements to monitor how institutional shareholders apply and report against the Code, the FRC should be able to commission third party research to assess the degree of compliance. However, as the IMA itself proposes, it would benefit from some degree of independent oversight external to the IMA. We would also stress that the survey is not a substitute for an independent audit opinion.

**Concluding Remarks**

In closing, we remain committed to discharging our stewardship and corporate governance responsibilities as a major UK institutional investor, which we believe is very much in the long term interests of our own beneficiaries. We believe that the proposed Stewardship Code, with some changes, under the FRC's oversight will help both us, as an asset owner, and our asset manager intermediaries, as well as other UK institutional investors, all in fulfilling better our respective responsibilities in a transparent and effective manner. We share the FRC's view that the Code can contribute to a significant improvement in the stewardship of UK listed companies and that the potential benefits are large if the Code is applied by a sufficient number of institutional investors.

We hope these comments are helpful and look forward to further developments in the evolution of the Code.

Yours sincerely



**Frank Curtiss**  
**Head of Corporate Governance**