

FRC Consultation on a stewardship code for institutional investors

submission by Tomorrow's Company

April 2010

1. Introduction and Summary

This draft response sets out Tomorrow's Company's vision for an effective Stewardship Code. Appendix 1 sets out comments on those questions to which our own work has been particularly relevant.

Background

The proposal to create a Stewardship Code, and the current consultation, are both welcome. Indeed they are closely in tune with growing body of work which Tomorrow's Company has been undertaking in its quest to map out an agenda for Tomorrow's Governance. This builds on the work which we have been doing in this area over the last 15 years and which is summarised in the textbox on the right.

Most recently in the last six months we have completed three reports which are relevant to this consultation:

- *Tomorrow's Innovation, Risk and Governance*
- *Tomorrow's Owners - defining, differentiating and rewarding stewardship*
- *Tomorrow's Corporate Governance: bridging the UK engagement gap through Swedish-style nomination committees.*

These three reports have already been submitted to the FRC and we would request that you read this submission alongside the reports, and particularly the agendas for action that they set out. The ideas and recommendations in this submission draw on this body of work.

We have also now instituted the Good Governance Forum with the support of business, investors and advisors and the Forum will also be consulted as further stages of the FRC consultation unfold.

Our stewardship recommendations will in due course be developed in dialogue both with the Forum, and with the partners of the Tomorrow's Owners project which has played such an important part in promoting the concept of stewardship over the last 18 months.

As Sir Christopher Hogg has observed, the introduction of a stewardship code for institutional investors is a development of great potential significance for the governance and performance of UK listed companies. But stewardship means different things to different people and there is much hard thinking, design, and testing to be done if the potential is to be fulfilled. That thinking has to start with a clear idea of what stewardship means, why it is important, and what will be needed to make it a reality. This submission is offered as a constructive contribution to the process.

The first Tomorrow's Company report in 1995 helped lead to a reformulation of the duties of directors in the UK around the obligation to promote the success of the company.

Since then Tomorrow's Company has made the case that:

- In the UK all directors have the same obligations and that executive directors should have separate contracts for their role as board members;
- Non-executive directors need to spend more time getting to know the business;
- The gap between stated values and actual behaviours in a company should be a crucial focus for boards;
- The investment system needs to be changed so as to better align the intermediaries with the interests of their ultimate clients and better hold companies to account;
- The stewardship of companies is a responsibility shared by directors and shareholders;
- Better governance depends on a culture of constructive challenge, greater diversity of thinking and experience, and a stronger emphasis on behaviours.

Summary of Recommendations

The Stewardship Code has the potential to be a significant step forward in improving the governance of companies in the UK. As has been the case with the Combined Code, we expect the Stewardship Code to evolve over time. To achieve the full potential of this innovation, there needs to be a clear idea of what stewardship is. The Stewardship Code presented by the ISC represents a useful starting point but it is too limited and too vague. It does not offer a comprehensive view of the standards that should be aspired to. We have provided our own definition of and principles for stewardship.

At this initial stage we would recommend that the FRC focus on:

- Defining stewardship and enabling clients and companies to differentiate between institutional investors at different points along a stewardship spectrum.
- Identifying the steps needed to encourage a critical mass of beneficial owners and fund managers who take their responsibilities seriously.

Over time we would recommend to the FRC that it works to:

- establish clear criteria and, if necessary, metrics by which clients and public can judge what is being done and thereby hold fund managers accountable,
- enable effective collaboration and burden-sharing between different institutional investors to overcome the difficulties caused by the wide dispersal of investment institutions.

Contents of this submission

- Why stewardship is essential (p4)
- What stewardship means (p5)
- Stewardship in capital markets (p6)
- Tomorrow's Company Stewardship Principles (p9)
- How a Stewardship Code could be implemented (p11)
- Stimulating a Demand for Stewardship (p12)

- Appendix 1: Answers to specific FRC questions (P14)
- Appendix 2: Stewardship principles - questions to assess stewardship (P16)

2. Why stewardship is essential

In our earlier work we have explained why the involvement of institutional investors in the stewardship of listed companies is vital for the creation of long term shareholder value. Without it the managers of companies are not held properly to account. Over-dominant chief executives are not held in check. The company's time horizon starts to shrink until it matches the tenure and the personal interests of its current executives. Risky business models go unchallenged. Boards give in too easily to excessive remuneration packages demanded by the executives. The opportunity for challenge is available only at through the too often ineffective ritual of the Annual General Meeting. The majority of shareholder communications is in the form of investor relations road shows where executives hold short and usually separate meetings around the world with fund managers and repeat a carefully prepared presentation about the prospect for earnings.

Companies need a deeper level of dialogue with shareowners who have an economic interest in their long term performance. They should be challenged both on their current performance and their future prospects, by owners who want to know about everything from the robustness of their business model, their reputation with customers, their licence to operate with the public, the strength of their ethics and their culture, the risks associated with their environmental impact, their progress on innovation and technology and their succession planning.

There is nothing automatically unhealthy about the rapid trading of shares. The market needs liquidity. But a capitalism in which there is no serious exercise of stewardship in the interface between investors and boards is an unaccountable capitalism. It is a system in which the gulf between society and business grows bigger, and with it comes a climate of public hostility to business from which stifling regulation is the predictable outcome. As Sir David Walker showed in his report, the costs from a lack of stewardship in the financial sector ended up being borne both by the taxpayer as well as the shareholder.

Stewardship should not get in the way of a company's entrepreneurial spirit. The best stewardship is light-touch and company-specific. It is the application of a measured judgement by an owner or part-owner who has a stake in the future success of the company in question. Such stewardship is unlikely to be achieved by relying on the generalised recommendations issued by proxy agencies. Not everyone will be a long-term shareholder, but we need a critical mass of engaged long-term shareholders to ensure the best use of assets and resources in our companies for the long-term benefit of shareholders and the societies whose health depends on the contribution of vibrant and responsible business.

3. What stewardship means

The starting point for this consultation needs to be with the definition of stewardship. Until there is clear agreement on what is meant by the term, there is a danger of confusion

Nowhere in the current text is there a definition of stewardship. The following terms are variously used in the FRC's introduction in the context of the workings of a stewardship code:

- "active share ownership" (Section 1.1)
- "take on the responsibilities of owners" (Section 1.2)
- "asset managers act diligently and in the best interests of the ultimate owners" (Section 1.3)
- "engagement between institutional investors and boards of listed companies" (Section 1.5)
- (quoting Sir David Walker) "better engagement between fund managers acting on behalf of their clients as beneficial owners, and the boards of investee companies" (Section 1.6)

In its document the ISC does not define stewardship either. It uses the following terms:

- "The code aims to enhance the quality of the **dialogue** of institutional investors with companies 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" (Introduction and Scope)
- "The code sets out best practice for institutional investors that choose to **engage** with the companies in which they invest" (Introduction and Scope)
- "How investee companies will be **monitored**; the strategy on intervention; how stewardship is integrated with the wider investment process; the policy on voting; the policy on considering explanations made in relation to the Combined Code" (Guidance under principle 1)

Our definition of stewardship

Stewards are people who look after the resources entrusted to them. The concept of stewardship has a long tradition. It describes any situation in which people are looking after assets on behalf of others. For example, it is often used to describe the responsibility which human beings have to look after the natural assets of our environment.

In the context of a company or of businesses more generally, we define it as

'the active and responsible management of entrusted resources now and in the longer term, so as to hand them on in better condition'.

In other words, stewardship is the process through which shareholders, directors and others seek to influence companies in the direction of long-term, sustainable performance that derives from contributing to human progress and the well-being of the environment and society.

4. Stewardship in capital markets

It is simple enough to apply the concept of stewardship to the investor in a family business. It is more complicated to apply it to investment in quoted companies. In publicly listed markets there tends to be a long value chain which connects the ultimate investors at one end with wealth creation at the other. Each intermediary in the system can be seen to be a steward: they have assets entrusted to them and are accountable for deploying those assets to the best advantage of their clients or beneficiaries.

All of those who occupy intermediary positions along this chain have to reconcile two kinds of stewardship obligation. They need to forward along the chain to the performance of the underlying assets in which they are invested, but equally they need to look back up the chain to the beneficiaries and clients to whom they must give an account of their investment performance. The aim of a stewardship code must ultimately be to offer criteria for how well this stewardship is exercised at all points in the chain, having regard to both stewardship responsibilities.

If we look at capital markets through the eyes of the finance director of a quoted company, the market is applying two disciplines which should help keep the company efficient and encourage its growth and survival. One is the discipline of stewardship; the other is the discipline of the share price, and through it, the market in corporate control.

The discipline of stewardship operates through dialogue, challenge, reporting and accountability. It serves to remind managers that they are not in their jobs to serve themselves but to create value for shareholders, tomorrow as well as today. This discipline, if it operates properly, is a vital protection against executive greed and short termism.

There is now a growing imbalance between the two disciplines. The share price discipline has become stronger, with shares more rapidly traded across the globe. At the same time in dispersed shareholding markets, the stewardship discipline has, overall, become weaker. Company CEOs and finance directors spend a large part of their time presenting to investors, but, as the recent financial crisis demonstrated, those investors who want to challenge management find it difficult to do so effectively through these channels of communication.

Too few fund managers see their interest being served by exercising stewardship. All the time they are acting in isolation of each other, this reluctance to engage may be harmful but it is understandable: each shareholding is such a small fraction of the total ownership of the company. Too few pension funds issue clear stewardship instructions in the mandates they issue. There is an obsession with relative performance at the expense of absolute performance - beta not alpha is the focus.

There has been too little willingness among asset managers to be open in the way they reach voting decisions. It is also worth considering why it is appropriate that when a fund manager's stock is loaned out by the custodian to enable a third party to take a short position, the right to vote is handed over as well. Traditional long-only fund managers who do take their ownership responsibilities seriously can find themselves without the votes they thought they had in important governance situations.

From our own earlier work on the investment system (especially Restoring Trust 2004) it has become clear that many intermediaries in the capital markets appear to think that whole system exists for their benefit, rather than for the benefit of the savers at one end and the wealth creators at the other. For investors as for managers, the discipline of stewardship is helpful in reminding them that the system does not exist to serve its suppliers, but to serve its users - savers and investors, on the one hand, and the wealth creating system on the other.

To deliver enduring returns the system needs all its players to have one eye on its underlying health. Intermediaries deserve to survive, and will ultimately survive, only to the extent that they contribute to serving these two groups. And a necessary condition for their survival is that there is a balance maintained in the capital markets between trading and owning.

Capital markets cannot function without trading. But, as recent experience has confirmed, capital markets without stewardship represent an unmanaged risk both for shareholders and, in some case, for taxpayers and citizens.

Or, as Sir David Walker put it in his review (para 5.7):

“As a matter of public interest, a situation in which the influence of major shareholders in their companies is principally executed through market transactions in the stock cannot be regarded as a satisfactory ownership model, not least given the limited liability that shareholders enjoy. The potentially highly influential position of significant holders of stock in listed companies is a major ingredient in the market-based capitalist system which needs to earn and to be accorded an at least implicit social legitimacy. As counterpart to the obligation of the board to the shareholders, this implicit legitimacy can be acquired by at least the larger fund manager through assumption of a reciprocal obligation involving attentiveness to the performance of investee companies over a long as well as a short-term horizon. On this view, those who have significant rights of ownership and enjoy the very material advantage of limited liability should see these as complemented by a duty of stewardship.”

Asset managers cannot have their cake and eat it: either they accept that ownership of shares carries with it obligations, and so are involved in the ownership dialogue and earn business from people looking to have ownership rights exercised on their behalf; or they are honest in saying that they do not accept that ownership has obligations, in which case companies and pension funds can treat them accordingly. What is inconsistent - both for pension funds at one of the chain and companies at the other - is to treat those asset managers who have no desire to exercise the obligations of ownership the same as those who are serious about ownership.

The exercise of the responsibilities of ownership calls both for monitoring and for constructive dialogue between investors and companies.

In his review Sir David Walker identified the following subject matter areas for monitoring by institutional investors (para 5.30)

“Apart from major specific issues related to remuneration policies, and matters of principle such as appropriate safeguarding of pre-emption rights, the focus of fund managers in the monitoring part of their engagement initiative in normal circumstances, where there is no event or development to cause specific concern, should relate to:

- *Familiarisation with and assessment of the quality and capability of the leadership of the company, most prominently covering the chairman and CEO;*
- *Satisfaction to the extent possible that the board and its committees are appropriately composed and function effectively;*
- *Understanding and broad endorsement of the company's principal strategies and objectives, including in particular the approach to remuneration and its risk appetite; and*
- *Appraisal of the company's performance in delivering the agreed strategy and acting on this as required.”*

To make this monitoring effective, there needs to be regular dialogue, focused on future value creation, through which institutional shareholders develop a deep understanding of what drives a particular company's business success. Companies need to supply the right information, but investors and their agents also need to ask the right questions and be encouraged to do so.

Having defined stewardship, the next step for the FRC in building any stewardship code for investors is to find a way of codifying the processes and questions through which investors arrive at this understanding. Our work on the Tomorrow's Company Stewardship principles offers a starting point for this.

Stewardship is the active and responsible management of entrusted resources now and in the longer term, so as to hand them on in better condition'.

Stewardship principles

Setting the course: attention to clarity of purpose, roles and relationships

Driving performance: attention to performance and improvement

Part of the landscape: attention to the wider world

Planting for the future: coherence over time

5. Tomorrow's Company Stewardship Principles

By studying the approach to stewardship of different kinds of company and shareholder we have crystallised stewardship into four *Tomorrow's Company Stewardship Principles*. Each principle is supported by a series of diagnostic questions which could inform an evaluation framework or scorecard for assessing the stewardship of a company.

The principles are:

- Setting the course: attention to clarity of purpose, roles and relationships
- Driving performance: attention to performance and improvement
- Part of the landscape: attention to the wider world
- Planting for the future: coherence over time.

The principles are summarised below and the questions are fully detailed in Appendix 2. They can form the basis for evaluating the stewardship of a company by its board in partnership with its shareholders. In applying these principles, boards and shareholders will naturally take account of the specific mix of resources entrusted to them, including the relationships with customers, suppliers and authorities, the talent and creativity of the people and the culture in the business and the quality of leadership and management.

Setting the course: attention to clarity of purpose, roles and relationships

Stewardship exemplars insist on clarifying purpose and respective roles and relationships. This includes being transparent about what the organisation is for, what it believes, and to whom it is accountable. The focus is on the arrangements for accountability, and how the different parties which are needed to make stewardship effective will work together and whether they are investing sufficient resources to achieve this. This principle reflects the need to insist on clarity, transparency and consistency in how the company is run.

This means being involved, thorough, honest and uncompromising in upholding the importance of stewardship - defining and publishing the purpose and philosophy of the company, making a clear, public statement setting out the relationships between the owners, the company and its other stakeholders, and the roles and responsibilities of each party. And it means being both open about and faithful to these commitments, and being accountable for the long-term as well as the short-term health of the company.

Driving performance: attention to performance and improvement

Unless an organisation gets the basics right, it will not survive. Stewards have an eye on the current and future operational performance, looking at the organisation's approach to all its relationships and resources and asking whether they are making the most of the opportunities available. They are making sure the organisation is as robust and resilient as it can be and that it is in a position to respond quickly to the unexpected. Good stewards are always looking for improvement - better products and services, better relationships, better suited to the environment. No matter how good things are there is a sense of confident restlessness.

Good stewards engage in uncomfortable conversations that challenge the status quo and the assumptions that underpin the business model. They insist on evidence. They encourage constructive challenges to current practices and adapt readily when required. Outstanding performance is a cause for celebration, but also for challenge, so that the underlying levels of risk are understood and managed.

Part of the landscape: attention to the wider world

Good stewards look outwards. They act on the basis that they are a part of a system that can be influenced. They recognise that the success of the company is bound up with the health of its surroundings. Good stewards engage with key stakeholders, picking up external perspectives. Through this engagement they are aware early of new threats and opportunities that are emerging from the external environment. They handle challenges effectively, acknowledging that others have positive contributions and testing all perspectives for their impact on the future of the company. They see the connections between the prosperity of a company and its external context - in terms of training, talent, social stability, environment and all those other factors that affect its capacity to operate, and get involved in those issues. They safeguard the company by seeing it as part of something bigger and are clear of its place in the external environment.

This means achieving the company's objectives through paying attention to more than the narrow interests of shareholders, employees, or any other stakeholder. It means seeing the company as something more than the tangible benefits employees or shareholders take from it - and believing that the more you put into a company, the more you and all its stakeholders will get out. Some people would describe this principle as enlightened self-interest; others express it as 'we are all in this together'. Others have seen the company as a force for good. Whatever the label, this principle is not about the sacrifice of corporate interests to those of others: it is about the intelligent pursuit of self-interest through mutual advantage, and the fresh opportunities and improved risk management that come from a heightened peripheral vision.

Planting for the future: coherence over time

While maintaining a relentless focus on the organisation's current health, good stewards balance this with a sense of its future potential and health. Short-term survival is a part of stewardship, yet there is a consistency and coherence between the actions taken in the short-term and the long-term objectives.

For boards, this can sometimes mean being robust in resisting the pressure from some investors for premature distribution of profits. For investors, this can sometimes mean supporting the directors' desire to invest in areas which may not immediately be linked to rises in the share price - like talent or leadership development, or health and safety. It may sometimes mean stimulating the company to grow organically or through acquisition, but it could also mean restraining the 'empire building' tendencies of acquisitive CEOs whose desire to run a bigger company may not be in the interests of shareholders.

This is not about saying that the long-term is more important than the short-term. Companies and their boards need to balance both. This principle is about recognising that short-term and long-term success are both important, and ensuring an adequate focus on, and investment in, talent and infrastructure for the future without unduly neglecting the present. Stewards are aware that a series of short-term decisions can undermine a long-term objective and act to maintain the consistency between the short- and long-term.

6. How a stewardship code could be implemented.

The Tomorrow's Company Stewardship principles offer a starting point at one vital link in the chain - that which connects the fund manager to the investee company. But this is only the first stage in generating principles that will properly inform a stewardship code.

From this point, it will then become necessary to apply the same basic principles and generate criteria for assessing the exercise of stewardship in a way that is relevant and practical at each point along the investment chain. Thus a pension fund trustee will need a version of the principles which enables her or him to assess whether the that pension fund's mandate is being defined and monitored in a way that is consistent with that fund's stated commitment to stewardship. Equally a fund-of-funds will need a version of the principles that enables it to be ranked for the robustness of the process it uses to assess each of the funds of each of the asset managers it has chosen.

A spectrum of stewardship

Many shareholders may never wish to exercise stewardship and may be able to justify this position as being consistent with their investment style. This may not matter if other shareholders take a lead and exercise that stewardship. But every company needs stewarding and if investors as a whole fail to take up their share of this responsibility, the management may not be called to account.

The spirit and intent of Sir David Walker's recommendation, and of the ISC code, is that there is a spectrum of possible levels of engagement; that the beneficial owners and other clients of fund managers should be clear where on that spectrum their fund managers commit themselves, and that they then can be held accountable for their performance against that level of commitment.

What we need to avoid is a fruitless exercise in compliance, where fund managers dress up the least ambitious levels of engagement in something which claims the label of stewardship. While further work may need to be done, we would suggest that there might be five readily recognisable levels of activity along the stewardship spectrum:

1. *No engagement*
2. *Voting practices* - establishing and operating a clear corporate governance policy on votes at AGMs
3. In addition to 2), *reactive engagement*- monitoring of and dialogue with the CEO and Chairman but full process of engagement only when trouble has been flagged or the company's explanation, e.g. for non-compliance with a provision of the Combined Code, is felt to be unacceptable.

The ISC's Stewardship Code would provide a basis for assessing the stewardship approach and performance of institutional investors for these three points along the spectrum. However, stewardship is more than reactive management, so subsequent points on the spectrum could be:

4. In addition to 3) strategic engagement - that is, an investor which recognises its obligation to participate in the process necessary to make engagement effective and thereby plays its part, both individually and with other like-minded investors, across a range of relevant activities such as engagement in the nomination of directors; regular strategic dialogue and challenge; regular engagement not only with the Chairman/CEO but between fund managers and each NED;
5. In addition to 4) stewardship engagement- direct exercise of ownership responsibilities, possibly on a portfolio restricted to allow focus, or through the shared exercise of such stewardship with other investors across a wider portfolio, with the subject matter of that engagement being consistent with the areas mentioned by Sir David Walker - namely assessment of leadership, approval of board and committee composition, endorsement of strategies and objectives, and appraisal of performance.

The four TC stewardship principles offer one basis for prospective clients to assess the institution's processes. Further work needs to be done to develop these.

It cannot be assumed that an asset manager will employ the same levels of activity across the whole of its portfolio. This makes the evaluation of an asset manager more complicated. The client will need to know whether a particular asset manager applies a common standard of stewardship everywhere, or different standards in different funds, or a mix of standards within a fund.

7. Stimulating a demand for stewardship

The FRC is right to recognise that it is important to find ways of encouraging market participants to adopt the stewardship standards outlined in the code.

There need to be mechanisms which bring investors together in a proactive way at the level of the company where the stewardship makes an impact. Tomorrow's Company has suggested that this could start with investor involvement in nomination committees but there may be other mechanisms which draw a fragmented group of investors together into an effect ownership group. Globalisation may make the logistics more complicated, although the Swedish experience is that such mechanisms do provide a basis for engaging international investors in a meaningful way.

In Sweden over 15 years, institutional investors have become actively involved in company nomination committees.

Initially lobbying for these changes came from the Swedish Shareholders' Association and in due course media coverage and peer pressure contributed to the involvement of many institutional shareholders. While there was initial resistance and scepticism from some quarters, over time many institutional investors have come to recognise the value of the change and have developed the resources required to contribute effectively.

This experience is a reminder of the importance of pressure from the beneficial owners. Pension Fund Trustees are, of course, an important catalyst for change. Through the mandates they give they can seek higher levels of stewardship. Like Lord Myners, we would argue that the exercise of stewardship is a necessary part of fulfilling their fiduciary duty. (See Paul Myners in <http://www.ft.com/cms/s/0/ccaee10a-03d1-11df-a601-00144feabdc0.html>) .

The role of index funds and so-called passive investors is also vital. Discussions need to be held with these groups to establish what changes would be needed to encourage them to put more resources into the exercise of stewardship. Options include some kind of a levy raised on those who buy shares but exercise no stewardship, and the imposition of a universal fiduciary duty on all fund managers.

If there is greater public awareness of the responsibilities of investors and the contribution which stewardship makes to securing good governance and protecting the value of investments, and if there is also greater transparency about the stewardship performance of different institutions, then this should provide a firm basis for a subset of asset managers to start competing for business on the basis of their stewardship effectiveness. The FRC should consider how it might directly or indirectly stimulate such a process; for example through 'kitemarking'.

In time, boards and investors could be publicly ranked or kite marked on their success as stewards, leading to the development of a category of investors who are explicitly recognised as effectively exercising their responsibilities as stewards, and who gain competitive advantage for doing so. For example, a straightforward starting point would be to identify which of the questions which relate to each of the Tomorrow's Company Stewardship principles in Appendix 2 are addressed by boards and by shareholders, how often they are discussed and the amount of time devoted to these discussions.

Another way of stimulating demand might be for reporting requirements which would require fund managers to give examples where they had deviated from normal benchmarks and had created value for the ultimate beneficiaries through active stewardship engagement.

Appendix 1: Answers to specific FRC questions

1. *Should the FRC accept oversight of the Code in its current form, or should amendments be made (para 1.16)?*

The stewardship code needs to be more robust by defining stewardship and more inclusive by enabling differentiation between different levels of activity. The ISC code is too limited in its ambition and too vague. For example, there is the danger that institutional investors will feel that merely instructing a proxy agency to vote on one's behalf is counted as stewardship. Those reporting against the code need to be able to categorise themselves and report meaningfully against a set of well defined criteria. We have offered five categories for consideration.

2. *The scope of the code, its disclosure and monitoring arrangements (para1.17)*

We would suggest that all parties involved in the management of equity investments on behalf of others should be encouraged to apply the code on a 'comply or explain' basis. We envisage this covering both asset owners and asset managers and the advisory agents they employ, such as investment consultants and voting agencies. There should be a public list of who has signed up to the code and each signatory should report publicly how they are meeting the code's requirements.

3. *Lessons which may be learned from experience outside of the UK (para2.18)*

We have looked closely at the Swedish system of governance and particularly at how, over 15 years, institutional investors have become actively involved in company nomination committees. The experience from this development is that demand from beneficial owners and other clients is important. In Sweden initial lobbying for changes came from the Swedish Shareholders' Association and in due course media coverage and peer pressure contributed to the involvement of many institutional shareholders. Also, while there was initial resistance and scepticism from some quarters, over time many institutional investors have come to recognise the value of the change and have developed the resources required to contribute effectively. A crucial feature of this experience is the way that, without compromising the authority delegated to the board or to executive management, it offers a mechanism for shareholder cohesion at the mechanism of the individual company, and builds a habit of ownership collaboration between different asset managers which is then valuable when other issues arise.

4. *What are the responsibilities for engagement of institutional shareholders and their agents to the beneficial owners? Does the ISC Code cover the relevant responsibilities?*

Sir David Walker and the ISC both state that these responsibilities are currently defined by the pension funds and other beneficial owners. Many beneficial owners are operating under a fiduciary duty to their beneficiaries, which means that they should not only be looking to achieve particular financial outcomes, but also should be assessing the risks inherent both in their investments and in the investment system as a whole. For example, many parties now argue that unless environmental, social and governance considerations are built into investment arrangements, then there could be a breach of the fiduciary duty. The ability of the ISC code to cover these responsibilities is not clear cut. It will be important for beneficial owners to define more clearly the level of stewardship they wish to see exercised by all those to whom they delegate responsibility.

5. *What are the responsibilities for engagement of institutional shareholders to the UK listed companies in which they invest? Does the ISC Code cover the relevant responsibilities?*

Taken together, Institutional investors have a strong self-interest in exercising stewardship so as to protect and enhance the value in their investments. Elsewhere we have also argued that they have engagement responsibilities owed to the companies in which they invest from the responsibilities that follow from being an owner of shares. Our analysis, set out in *Tomorrow's Owners: Stewardship of Tomorrow's Company*, shows that major shareholders already have a general responsibility to the company, including a responsibility not to cause harm through the owner's actions. The question therefore is how these responsibilities are to be discharged.

Some fund managers have no interest in stewardship. However, if only some market participants are going to do the 'heavy lifting' for an activity that is acknowledged to be a public good, then it follows that the inactive group should in some way contribute to the resources burden which they are leaving to the more active.

It has been suggested that some form of fiduciary obligation should be placed on fund managers. This question would need careful investigation, as it appears to be based on the assumption that one can generalise across different types of institution investors about these responsibilities.

Appendix 2: Stewardship principles - questions to assess stewardship

Setting the course: questions for companies

- How similar are the views of the board and the shareholders about the future of the company's industry and the company's place in it, and what steps are taken to align these views?
- Does the board create opportunities for effective discussion between the board and shareholders about the company's strategy?
- What are the criteria for adapting the company's purpose and role and how have these been developed with input from shareholders?
- What are shareholders' criteria for the board being effective?
- Is the company clear about the characteristics of the stakeholders it wishes to engage with and the terms on which it will engage with them?
- Do shareholders have opportunities to have effective dialogue with the board?
- Do boards have opportunities to have effective dialogue with the shareholders?
- Are shareholders involved in nominating board members and overseeing remuneration arrangements?
- What mechanisms are there to hold the Chairman and board to account for their stewardship? Does the AGM fulfil this purpose?
- How clear are the executive directors about the different duties and responsibilities they have to the company and to shareholders as board members and as executives?

Driving performance: questions for companies

- How do the board and the shareholders keep abreast of their customers' experience?
- In what ways do the board and shareholders keep their finger on the pulse of the workforce and skill base of the company?
- How does the board review the company's arrangements for dialogue with and learning from stakeholders?
- How do the board and the shareholders monitor the culture of and the behaviours in the company?
- How does the board keep abreast of risks in the supply chain?
- How are leading indicators built into business strategy, planning and reporting and over what horizon?
- What are the board's criteria for changing processes and procedures and how have these been developed with input from shareholders?
- How effective is the management information system at keeping directors and so shareholders informed of the company's performance and the changes that need to be made?

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Part of the landscape: questions for companies

- How does the board map the company, and its risks and opportunities, on to its wider environment?
- How does the board define value beyond just financial metrics?
- How does the board anticipate and deal with potential conflicts between different stakeholders?
- How does the board assess the significance of changes in public policy and the wider environment and the potential impact of these changes on stakeholders?
- What criteria does the board employ for engaging with public policy-making processes and how have these been developed with shareholders?
- What account does the strategy take of the opportunities and risks presented by the company's key relationships?
- How well are the key relationships identified, defined and monitored?
- What dialogue does the board have with shareholders or their representatives on these issues?
- Do board and shareholders pay as much attention to the spirit as to the letter of regulations, contracts and obligations?
- How effectively is the management of the company's relationships reflected in the remuneration and incentive scheme for the directors?

Planting for the future: questions for companies

- What is the balance between the importance given to short-, medium-, and long-term performance indicators?
- Who decides this balance? Does it come from the board or from investor pressures?
- What steps does the board take to ensure that the short-term goals of the company and its shareholders are consistent with the company's long-term strategy?
- Does the board have a clear picture of its shareholders' expectations for the short, medium and long-term performance of the company?
- Is the company investing sufficiently in key building blocks that will sustain long-term performance?
- How effectively are the short, medium, and long-term objectives of the company reflected in remuneration and incentive schemes?