

## **Financial Reporting Council's Consultation on a Stewardship Code for Institutional Investors**

### **Response from UNISON's Capital Stewardship Programme, April 16, 2010**

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#### **Introduction**

UNISON's Capital Stewardship Programme is pleased to be able to respond to the FRC Consultation on a Stewardship Code for Institutional Investors.

UNISON represents 1.3 million members, many of whom contribute to funded occupational pension schemes, or have savings and insurance policies with commercial providers - making them a significant section of the UK's ultimate beneficiary owners of corporate stock.

Following the 2004 Pensions Act, the trust boards of occupational pension funds must now include at least one-third of their number from scheme members, nominated by election or by representative bodies. UNISON is one such legally recognised sponsoring body for "member-nominated trustees" (MNTs) on occupational pension boards covered by the Act.

UNISON's Capital Stewardship Programme was begun in 2007 to provide education, a forum and supporting materials for member nominated trustees (MNTs) on pension boards, and member representatives on LGPS investment panels and committees. The programme has carried out research on behalf of MNTs, including:

- Fiduciary law and responsibilities of MNTs
- Beneficiary representation on LGPS funds
- Implications of the Universal Ownership investment approach for fiduciaries on large diversified funds
- Performance analysis of LGPS funds

The Programme is in direct and regular communication with more than 1,500 MNTs and branch representatives concerned with pension fund investment on a collective investment of more than £145bn at 2008 values. In its communications with MNTs, the Programme has both highlighted and sought views on the ISC Code, the UN Principles for Responsible Investment and the Myners Code.

This submission would especially stress the importance to the success of the Stewardship Code of a much improved awareness by the ultimate fiduciary

owners (as opposed to their agents) of the full extent of their powers and duties in governance of all their assets.

Member-Nominated Trustees should be a key constituency for the Stewardship Code, because they are direct representatives of end-beneficiaries. But as lay appointees, they also require special assistance if they are to be able to effectively challenge the widely-perceived inertia and vested interest of professional agents and company boards in the adoption of improved stewardship and governance of UK-originated capital assets.

**Abbreviations used:**

The Code: The Stewardship Code

TPR: The Pensions Regulator

IGG: Investment Governance Group

FSA: Financial Services Authority

ISC: Institutional Shareholders Committee

UNPRI: United Nations' Principles for Responsible Investment

**Response**

**General remarks**

- We believe the current ISC Code is an advance on its predecessor, and therefore this response is largely an attempt to suggest methods for improving its effectiveness.
- The term “institutional investors” includes both those covered by fiduciary law (trustees and fiduciary managers), and their agents. But the code should make it clear from the outset that in both law and current practice, those with fiduciary responsibilities are ultimately responsible for setting the governance agenda for the management of their assets by their agents and company boards.
- The Code should therefore focus primarily on the fiduciary owners as the necessary starting point for stewardship through the rest of the investment chain. Fiduciary owners can do this by establishing and regularly reviewing their stewardship principles, and setting in place contractual obligations on their agents, and collaborative relations with fellow fiduciaries to bring these principles into effect.
- In settling on any changes in the Code and its guidance, we would be grateful if the FRC would draw on the UNPRI’s “Fiduciary 2” report -- covering fiduciary duty, obligations on fiduciary owners, and current shortfalls in the application of governance duties in the investment chain. In particular, the report cites legal opinion that fiduciaries are not only legally obliged to treat ownership rights as assets over which they must

- exercise their duties, but also that to fail to do so may make them liable to the charge of negligence.
- We are in favour of mandatory publication of voting records and to annual elections of boards.
  - Collaboration between funds, encouraged by the Code and the Walker Review, is essential if stewardship is to be effective. Costs must not be prohibitive. This implies the following:
    - Fiduciary owners must be correctly identified, as well as their beneficiaries, so that prospects for shared interest can be established. The Consultation suggests that insurance policyholders are typical beneficiaries of insurance funds. We are aware of alternative legal views regarding ultimate beneficial ownership of all insurance funds, and we would ask that FRC ensures that its understanding of beneficial ownership of the different forms of insurance fund are clearly established in law.
    - For any individual company, its fiduciary owners, or their appointed stewardship agents, must be able to find and communicate with each other with ease.
    - Fiduciary owners should be able to share costs of research and engagement easily. Contracts with agents should therefore permit a method for sharing such costs, with only a modest additional income for agents where no additional work is undertaken by them.
    - Collaboration between fiduciaries implies that agents will increasingly be obliged to collaborate on behalf of their fiduciary clients. FRC may be in a position to set standards for such collaboration.
    - The effectiveness of Stewardship would be improved if fiduciaries' adoption of elements of the Code, and any additional stewardship principles, were more easily understood by companies and other asset issuers. There is therefore an argument for a central registry of fiduciary owner standards of stewardship that can be compared against shareholder registers. We would like the FRC to consider whether a stewardship registry could be established with the assistance of industry participants or UNPRI. Companies could compare their share register against this central register to get early indications of the stewardship positions of their shareholders.
  - Collaboration between funds on long-term stewardship initiatives aimed at higher absolute whole-portfolio returns for diversified portfolios implies a shift from brokerage activity by agents towards engagement activity. Costs for a stewardship approach should therefore be adequately covered by encouraging fiduciaries to adjust contractual agreements with agents so that stewardship is actively remunerated, unnecessary broking disincentivised, and research sharing facilitated.

- We would be pleased if the FRC would also consider whether current accounting standards for estimating liabilities in long funds, which are highly dependent on cyclical changes in market values, are an impediment to the adoption of long-term, stewardship-oriented investment strategies.

### **Detailed response**

Addressing the key issues on which the FRC seeks views (in the order set out in Appendix A):

#### Section 1: Introduction

*Policy Objectives (Para 1.14), currently including:*

- *Setting standards of stewardship*
- *Promoting sense of ownership and reporting against it*
- *Linking engagement to investment process*
- *Improving communication between shareholders and boards*
- *Secure sufficient disclosure to allow institutional shareholders' prospective clients to assess how managers are acting in relation to the Code*

The objectives of the SC could also include a clear reference to the underlying legal basis for improved stewardship of pooled assets, namely:

- The advancement of the principles of fiduciary law, and the duties of fiduciary owners to actively protect and advance the interests of end-beneficiaries.
- Advancing the awareness of fiduciary owners and their agents of their obligations and rights in the governance of assets

*Should the FRC accept oversight of the Code? (P 1.16)*

- UNISON's Capital Stewardship Programme has already favoured the role of the FRC in oversight of the Code, on the grounds that it brings the Code within a regulatory framework, and that the FRC's role in the application of Company Law ought to improve coordination between owners and management.
- If the FRC is to take on supervision of the Code, we believe it should co-opt the assistance of practising or former fiduciaries from large funds, with specific inclusion of Member Nominated Trustees (Para 1.16), or collaborate with the IGG, which includes some MNTs.
- The Stewardship Code should be included in TPR trustee understanding, and in training for professional qualifications relevant to the investment chain and its auditing.
- To avoid confusion among fiduciaries and agents, the FRC should set out clearly how its responsibilities dovetail with TPR, IGG, ISC and FSA

*Which institutional investors and agents should be encouraged to apply the code, what they should disclose and to whom, and with what monitoring arrangements? (P 1.17)*

- HMRC in attempting to define the application of EU Directives to the UK tax environment can find no legal definition of “institutional investor” in UK or European law. It is necessary for FRC to set its own definition of the categories of fiduciary and agent to which the Code is intended to apply.
- The definition could be by total volume of assets under ownership or management, and/or more than a certain number of end-beneficiaries. For example, funds, managers, consultants or custodians with responsibility for more than £100m under ownership or management, or managing all or part of the assets of more than 1000 end-beneficiaries.
- Given that the Code is attempting to align beneficiary interests in the governance of their assets throughout the investment chain, the Code should apply to all fiduciaries and agents serving funds falling within the definition.
- Public disclosure of fiduciary investment principles should be encouraged, as well as all voting records.
- To encourage collaboration between fiduciaries, the Code could encourage fiduciaries to reserve themselves, in contracts with agents, an ability to on-sell specialist research to fellow fiduciaries and their agents at rates aimed to share costs.

### Section 2: Background

*Experience of lessons outside the UK (P2.18)*

- US and Swedish experience of improving shareholder participation in the nomination of directors should be encouraged. We believe the FRC should look favourably at the “Tomorrow’s Company” response to this consultation, which refers to the inclusion of fiduciary representatives on UK board nomination panels.

### Section 3: Coverage of the Code

*Application to all UK Institutional Investors (P3.6)*

- As above. The Code should apply to all those fiduciaries and agents falling within the definition settled upon by the FRC.

*Barriers to application of the code (P 3.6)*

We believe that barriers to application of the Code include the following:

- Fiduciaries’ lack of understanding of their duty to consider the active use of ownership rights to further the interest of end-beneficiaries.
- Failure by fiduciaries to include stewardship criteria in their RfPs and contracts with agents (see UNPRI’s “Fiduciary 2”).

- Confidentiality clauses designed to prevent the sharing of research between fiduciaries.
- The reluctance of fund managers to raise stewardship matters with existing or prospective clients.
- Difficulties for fiduciaries in establishing collaborative initiatives with others.
- Current methods of estimating liabilities on long funds – which lead to an inappropriate focus on short-term valuation, rather than long-term absolute returns.

*Should agents be encouraged to commit to the Code? (P3.8)*

- Yes – to ensure the alignment of all members of the investment chain to the interests of end-beneficiaries in the prudent exercise of the ownership rights attached to their assets.

#### Section 4: Content of the Code

*What are the responsibilities for engagement of institutional investors? Does the ISC Code cover all relevant responsibilities?*

The responsibilities for engagement differ between fiduciary owners and their agents, and these should be set out separately, at least in the guidance, for:

- Fiduciary owners
- Investment Managers
- Consultants
- Custodians

For Fiduciary Owners these responsibilities should include:

- A recognition that the governance rights associated with assets are considered in law to be a component part of the asset, and therefore subject to active fiduciary stewardship.
- An understanding that a failure to include Stewardship criteria in investment policy and contractual arrangement could leave fiduciaries open to common law negligence claims.
- An understanding that they are not limited in their stewardship activity to activities within the Code, so long as this activity is compliant with their obligations.
- An understanding that their legal protection as fiduciaries is likely to be enhanced by dialogue and consultation with beneficiaries.
- The obligation to seek expert advice on stewardship and responsible investment
- To have a practical understanding of duties imposed on owners of each asset type through the mandatory regulation of agents and companies,

- such as communication with company boards, election of boards, moving motions, voting, calling of EGMs, remuneration policy, etc.
- A recognition that the governance of financial institutions requires “special case” treatment, due to the impact of governance on levels of credit, and lending policies that can affect overall absolute performance of funds by distorting overall economic performance.
  - The need for a practical understanding of duties proposed by the SC for best practice in stewardship of each asset type in the portfolio.
  - To have a practical understanding of methods of influencing stewardship – to include engagement, exercising voting rights, moving motions, adjusting stock and sector portfolio holdings, weighting of investment criteria on stewardship criteria, assessing the ability of company executives to execute company policy, to use stewardship and responsible investment metrics, collaboration with fellow shareholders and asset-holders, communications with company executives, and public statements regarding governance of assets, etc.
  - To consider influencing stewardship of assets and absolute returns through dialogue with regulatory bodies and other civil institutions.
  - To decide what weighting is to be given to long (stewardship-intensive) versus short asset holdings
  - To prepare a Statement of Investment Principles – to the minimum standard of detail of LGPS and Pensions Act requirements. We believe the Code should require a similar standard of public disclosure of investment principles by all fiduciaries to whom the Code applies.
  - To conduct a regular review of stewardship policies and experience.
  - To consider the adoption of the SC, and codes such as PRI.
  - To decide whether agents should be required to adopt SC or PRI codes.
  - To decide what stewardship capability is required of agents – including Corporate Governance and Environmental and Social Governance, as well as agent ability or attitude towards collaboration with fellow fiduciaries.
  - To decide whether agents should be subject to an independent audit of their stewardship performance.
  - To favour, as a default position, the inclusion of Stewardship and Responsible Investment criteria in all contracts and mandates with agents -- in legally binding language to protect themselves from negligence claims.
  - To include in RfPs that tendering agents state their attitude to the Code, and to their capability and experience of engagement.
  - To consider their performance horizons for agents.
  - To consider remuneration of agents for engagement performance (vs brokerage or asset value methods).

- To set the reporting standards on stewardship.
- To encourage, and provide facilities for, dialogue with end-beneficiaries over stewardship policies.

For Investment Managers these responsibilities should include:

- To raise engagement policy with clients when responding to RfPs, and in fulfilling contractual obligations.
- To develop collaborative arrangements with other agents tasked by their own or other fiduciaries with carrying out collaborative stewardship initiatives.
- To report back to clients their engagement activity and their collaborative activity with agents of other fiduciary owners.
- To develop expertise in engagement.
- To maintain dialogue with investee Investor Relations departments, and to make this correspondence available to clients.
- To offer training in the purpose and application of the Code.
- To share with clients their UNPRI assessment on Responsible Investment.

For Consultants these responsibilities should include:

- To ensure Fiduciaries are aware of their stewardship responsibilities as set out above.
- To investigate investment management stewardship practice.
- To investigate whether mandates, performance criteria and time horizons for Investment Managers are appropriate to the objectives of the fund and its Statement of Investment Principles.

For Custodians and/or Voting Agents

- To ensure that the fiduciary owner is clearly identified as the ultimate shareholder for company shareholder register, and other asset classes
- To report to fiduciary owners and agents regarding the adequacy of company share registers for identification of fiduciary owners for potential collaborative work.
- To report to fiduciary owners regarding the management of voting arrangements.
- To report to fiduciary owners any unusual by-laws or governance arrangements by companies or other asset-issuers that may be an impediment to application of the Stewardship Code.

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

- No. Guidance should aim at producing a separate and comprehensive view of relevant duties and powers to each of the major parts of the investment chain.
- Special consideration should be given to ensuring understanding among fiduciaries, especially lay fiduciaries, who are likely to have limited time, and limited understanding of industry conventions and terminology.
- The Code should use names for the elements in the investment chain that make clear whether they are end-beneficiaries, fiduciaries (i.e. bound by fiduciary law and standing higher in the chain than their agents), and the investment managers, consultants, custodians (bound by contract law, with a less exacting legal obligation and duty of care). The terms “institutional investor”, “beneficial owner”, “legal owner”, “shareholder” can include either fiduciaries or agents, and are therefore open to misinterpretation and should be avoided in the Code and in guidance.

*Does the code strike the right balance between over-specification and effectiveness and transparency?*

- The basic principles of the Code should remain simple, and allow adoptees to make progress in implementing its elements. Specification should apply to guidance targeted at the different elements within the investment chain.
- The reporting element should be detailed enough to permit analysis of problems with implementation, and allow adoptees to feel comfortable about expressing any issues they believe to be hindering their ability to comply with responsibilities and practices spelt out in the guidance.

*Are there parts of the code where further guidance is needed, or where existing guidance should be amended? (P 4.2)*

- See above regarding separate and comprehensive guidance to each part of the investment chain.
- The code should cover, or give guidance on stewardship responsibilities of fiduciaries and agents on all asset classes – domestic and overseas equities, treasury and commercial bonds, private equity, property, hedge, derivatives and cash. Stewardship advice typically refers to equity only, and without distinguishing equity in financial companies as a special case for stewardship. But fiduciaries need to be aware of the need for a whole-portfolio stewardship approach that typically will include:
  - Equity in financial services companies, where credit issue and lending policy may have a broader impact on the portfolio.
  - Contractual methods of ensuring adequate stewardship of Private Equity.
  - The duty to end-beneficiaries to assess the implications to the portfolio of proposed uses of treasury and commercial bond issues.

- Environmental and social stewardship of commercial and residential property.
- The operation of hedge funds and the potential impact of their activity on the rest of the portfolio.
- The potential role of derivatives in expanding credit issue.
- The role of speculative and leveraged investment assets in distorting markets.
- Guidance should include advice to all elements within the investment chain regarding freedoms and restrictions on collaboration arising from regulations on “acting in concert”.

*Does the Code adequately cover the content of Section E of the Combined Code? (P 4.4)*

- The wording of ISC code is preferable to Section E of the Combined Code. It should be made clear to fiduciaries, agents and company management that a whole-portfolio approach to maximising absolute returns may at times imply encouraging businesses to act beyond their perceived immediate self-interest, as discussed in the literature concerning Universal Ownership investment approaches.

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

##### *Items for public disclosure and disclosure to clients*

- Public disclosure should include all elements currently proposed by the ISC Code.
- Such disclosure could be required as part of a broader Statement of Investment Principles by all fiduciary owners of institutional assets subject to the Code, and the inclusion of a Stewardship report in annual reports by fiduciaries.
- UNISON members are typically members of the LGPS, which already has mandatory disclosure requirements regarding Statements of Investment Principles, a periodic assessment of the application of the Myners Principles, Funding Strategy, Communication Policy (to end-beneficiaries). We see no reason why these requirements should not be extended to all fiduciary panels falling within the application of the Code.
- Disclosure to clients should include: Voting records, engagement correspondence, implementation of the Code on behalf of the client, implementation of the Code by the agent.

##### *Monitoring application of the Code and reporting*

- The ISC had proposed that fiduciaries and their agents who wished to adopt the Code as model for their practice should be listed on their Website. We believe the FRC should find a method for implementing this

- proposal, possibly with the assistance of UNPRI, which already maintains a process for publishing and monitoring signatories to its Principles.
- Signatories should be required to indicate what role they play in the investment chain, and the total volume of assets for which they have responsibility. This would allow an estimation of level of adoption of respective elements of the code within each element of the chain of investment.
  - A centralised registry for monitoring is the preferable option for ease of comparison by fiduciary owners and professional and academic researchers. The FRC is encouraged to seek methods to establish and supervise such a centralised registry.
  - Reporting should allow signatories who aspire to the Code to indicate where they feel they have experienced barriers to the application of the Code.
  - A loose template for reporting, based on responses to this consultation, would allow comparability and therefore greater detail in monitoring where problems are arising in the application of the Code.

*Arrangements for reviewing the operation and content of the Code (P5.2)*

- We believe it is essential that both professional and lay fiduciaries are included in the review process, and that in recognition of their senior legal role, fiduciary views should be treated with greater weight than those of agents.
- If possible the FRC should seek to maintain a research capability that will allow the review panel to receive a comprehensive analysis of the extent of application of each major stewardship responsibility for each element within the investment chain.

*Specific information that should be disclosed by institutional shareholders and agents, and level of detail (p5.3)*

- See above

*Should above information or any other information be disclosed publicly? (5.6)*

- See above

*Structure of the Code, and best method of encouraging reporting on it (5.10)*

- Consideration could be given to structuring the Code according to the responsibilities of the separate agents within the investment chain.
- The FRC could maintain and review a proposed reporting template for each of the elements within the investment chain, with both quantitative and qualitative criteria.

- Reports on the application of the Code will need to be tailored to the respective responsibilities of the actors in the investment chain.

*Merits of independent audits of application of Code, and costs and benefits to asset owners (P5.14)*

- We believe there is merit to independent audits of application of the Code. The FRC could develop the reporting template in association with such auditors.
- Fiduciary 2 cites at least on Consultant claiming that application of UNPRI principles will result in improved returns and broader beneficiary interest.
- Commentators, such as Paul Myners, have suggested that fiduciaries with diversified portfolios should be orienting their agents towards absolute returns through improved stewardship, on the grounds that diversified portfolios benefit from overall economic performance rather than “zero-sum” churn of stock. There is an argument therefore that as brokerage costs fall, engagement costs can rise without increasing overall costs to beneficiaries, and perhaps both reducing costs and improving absolute returns.

*Merits of IMA survey or other approaches to monitoring application of Code (P5.21)*

We were unable to access the IMA survey format from the link provided. The survey might usefully include questions based on the issues raised above, for example:

- Do you proactively raise SC in all RfPs to fiduciary clients?
- How many staff specialise in Engagement?
- Do you provide a report of voting and engagement activity to clients (P 5.11)
- Do you require any confidentiality agreements that limit clients from sharing any material regarding engagement activity with fellow fiduciaries?

*Proposed approach to reviewing the Code (P5.22)*

- We agree that the Code should be subject to regular review and consultation.
- Monitoring of the application of the Code should seek to inform the review panel whether the “comply and explain” approach should be exchanged for a mandatory requirement for any part of the Code.
- Given their “senior” fiduciary role, Fiduciaries should be accorded adequate representation and consultation on regulatory bodies, with specific reference to fiduciaries nominated by beneficiaries (e.g. Member-Nominated Trustees on pension funds).

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Selected references

UNEPFI's 2009 Fiduciary 2 Report

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

UNEPFI's 2005 Freshfields Report

[http://www.unepfi.org/fileadmin/documents/freshfields\\_legal\\_resp\\_20051123.pdf](http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf)

Paul Myners, Speech to ICGN Conference on Corporate Governance 25 March 2010

[http://www.hm-treasury.gov.uk/speech\\_fsst\\_250310.htm](http://www.hm-treasury.gov.uk/speech_fsst_250310.htm)

Chris Hogg , Address to the ICGN Mid-Year Conference at the Guildhall, 25th March 2010

<http://www.frc.org.uk/images/uploaded/documents/Address%20to%20the%20ICGN%20Mid-Year%20Conference%20March%2020101.pdf>

Tomorrow's Corporate Governance

[http://www.forceforgood.com/Uploaded\\_Content/tool/243201011485875.pdf](http://www.forceforgood.com/Uploaded_Content/tool/243201011485875.pdf)

Guidance for Investor Relations Practitioners on the UK Governance Code.

[http://www.irs.org.uk/files/pdf/Consultation\\_march\\_2010.pdf](http://www.irs.org.uk/files/pdf/Consultation_march_2010.pdf)

Manifest comment on Custodianship

<http://www.manifest.co.uk/manifest-i/2002/0201-03JanMar/20020104custody.htm>