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The Investor Relations Society's Response to the Financial Reporting Council on Revisions to the UK Stewardship Code Consultation Document

Dear Mr Hodge

Thank you for giving us the opportunity to take part in the above consultation. I am pleased to enclose The Investor Relations Society's response.

The Investor Relations Society's mission is to promote best practice in investor relations; to support the professional development of its members; to represent their views to regulatory bodies, the investment community and government; and to act as a forum for issuers and the investment community. The Investor Relations Society represents members working for public companies and consultancies to assist them in the development of effective two way communication with the markets and to create a level playing field for all investors. It has over 600 members drawn both from the UK and overseas, including the majority of the FTSE 100 and much of the FTSE 250.

Investor stewardship has been one of the big issues for our members in recent years and we expect this will continue to be the case. We believe that investor stewardship is mutually beneficial to both issuer and investor and we endorsed the FRC's Stewardship Code from its initiation, stating in July 2010 that: "Communication between companies and their investors is a two way process so we strongly support anything which improves this. We will continue

to monitor the development of shareholder engagement and take part in the debate on stewardship". We consider that the introduction of the Stewardship Code usefully 'codified' existing investor relations practices. Accordingly, our members recognise the importance of regular investor meetings, with 86% meeting their top ten investors more than once a year. Furthermore, 67% of our members recently reported to us that their top ten investors are *actively engaged.*

In order to ascertain current thinking from IR professionals on the subject of stewardship we are running a series of 'IR Forums' to enhance engagement by bringing together investors with our members. Early conclusions focus on the need to make further improvements to the interaction between investors and companies while recognising that overall it is felt that most investors are already conforming to best practice in communication with companies and adopting the principles of the Code, and that the code had improved engagement of smaller investment funds in particular. There are areas in which we feel the Code requires revision in order to deliver on its overall objective and we are pleased to see that many of these are addressed in the proposed revisions as we discuss in our consultation response, with a summary of our key points below:

1) We do not consider at this stage there can be sufficient grounds for confusion over the basic terms at this stage.

2) The two fundamental considerations for IROs in ascertaining and encouraging investor stewardship are i) recognising which parties have voting rights and ii) identifying the party that understands the company and takes decisions regarding investment.

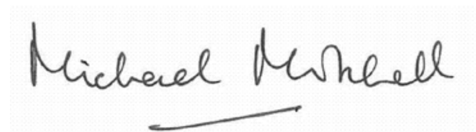
3) Time and personnel resourcing is a key issue for institutional investors and particularly so in the smaller houses.

4) Our primary concern over investor stewardship and the Code is the growing trend for institutional investors to outsource their stewardship responsibilities to third parties e.g. proxy advisory agencies.

Extrapolating from point 4 above, we would like to see Principle 1 of the Code expanded on the issue of proxy advisory to make it clear that proxy advisory firms should not be expected to assume institutional investors' *overall* investor stewardship duties. While we recognise the advantages of using these agencies for fund managers, it is essential for the long term

success of the Code and therefore the interests of issuers and investors that investor dialogue is not reduced to a prescriptive box ticking exercise for reasons of proxy advisory procedure. This we feel is contrary to the spirit and objective of the Stewardship Code.

Yours sincerely



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The definition of stewardship

We do not consider at this stage there can be sufficient grounds for confusion over the basic terms, as the underlying meaning is clear. Nevertheless, further clarity is helpful. 'Stewardship' can mean at least three things in the investment context – asset managers' stewardship of their clients' investment, company management's stewardship of the companies their investors own, and *investor stewardship* – investors taking an active role in companies they invest in. Therefore *The Investor Stewardship Code* might have been a more specific term for the Code (although at the risk of prompting further confusion as to whether stewardship *of* investors was the objective!).

The proposed revised definition: "Stewardship activities aim to promote the long-term success of companies so that the ultimate providers of capital also prosper" - is helpful for clarification, as is the proposed statement: "For investors, stewardship activities include monitoring and engaging with companies on matters such as strategy, performance, risk, remuneration and corporate governance, as well as voting".

The responsibilities of asset owners and asset managers

The diffusion of shareholder registers in recent years and the trend for outsourcing asset management from beneficiary owners to external asset managers requires some explanation regarding differing responsibilities and remits. Introducing the requirement for asset managers to account for, rather than just report their portfolio decisions: "Asset managers regularly account (rather than report) to their clients or beneficiaries for details of how they have discharged their responsibilities" - is a positive step, while again illustrating the multiple meanings of the terms stewardship, given that this relates to the stewardship duties of asset managers *to their clients* rather than *investee companies*.

However, as the voice of IR professionals in the UK, with a natural focus on the issuer perspective, we consider the two considerations for IROs in ascertaining and encouraging investor stewardship to be a) recognising which parties have voting rights and b) identifying the party that understands the company and takes decisions regarding investment. Often this is the same individual but not always, given the outsourcing trend previously mentioned. IR teams need to know who has been mandated to vote, and their likely investment decisions. We will therefore restrict our comments to this illustration, while recognising that there are occasions whereby beneficiaries instruct fund managers to vote in particularly ways for specific reasons.

The impact of the code

We understand that the large majority of asset managers are abiding by the code through the underlying 'comply or explain' principle. Time and personnel resourcing is a key issue for institutional investors, as is known, and is particularly the case in the smaller investment houses. Lack of resourcing can lead to box-ticking, failure to comply at all, or delegation of some stewardship responsibilities to proxy advisors. Smaller investment houses are naturally therefore likely to be hampered by the resourcing issue with regards their investor stewardship programme, and this is something that appears to be borne out by practical experience. Smaller investment houses will by definition find it harder to reach company management than, say, Blackrock or Fidelity due to prioritisation of management time. Working together though 'concert partying' gives the smaller houses a combined clout and there are precedents of this happening. It is rather difficult to say from issuer or investor perspective whether this has a net positive or negative impact as incidences vary on a case by case basis; however, there are seemingly more cases whereby a particular issue (especially those of executive remuneration) has motivated one or two small activist investors to organise a temporary coalition *against* a particular company policy than in *favour* of one. We have no objection to the principle: "At times collaboration with other investors may be the most effective manner in which to engage", but think that there should be a lesser emphasis on collective engagement *only* at times of significant corporate or wider economic stress as this implies that engagement is only necessary during challenging periods rather than *all* of the time.

We consider that much of the impact of the Code has been on the corporate governance of issuers. As part of the proposed code states: "Investors in the company also play an important role in holding the board to account for the fulfilment of its responsibilities". This reflects the numerous Government consultation papers and initiatives that have addressed corporate governance as a driver of the financial crisis. While our members welcome constructive engagement from investors the principle objective of the Code is to encourage behavioural change amongst *investors* foremost. We therefore welcome the following proposals in the revised code: "For investors, stewardship activities include monitoring and engaging with companies on matters such as strategy, performance, risk, remuneration and corporate governance, as well as voting. Engagement is purposeful dialogue with companies on those matters as well as on issues that are the immediate subject of votes at general meetings" and: "Institutional investors' activities include decision-making on matters such as allocating assets, awarding investment mandates, designing investment strategies, and buying or selling a specific security. The division of duties within and between institutions

may span a spectrum, such that some may be considered more asset owners and others asset managers. Each institution will wish to consider where on the spectrum they reside." These revisions are helpful as they reiterate the importance of investors assessing their own stewardship activities. We would suggest expanding upon this with a line similar to the following: "The Stewardship Code is only as strong as investors make it. Stewardship requires the will of investors to improve the companies they own in their clients' interests".

Engagement between investor and company is as old as public companies themselves – investor relations brought structure and process to this in response to greater demand from regulators and investors. The Code by definition acts to 'codify' the existing practice of investors 'stewarding' the recipients of their portfolio decisions. The Code is one consequence of the downturn to affect the UK economy in recent years and the resulting calls for action. In some cases it might have been that shareholders were lax in engagement on occasion prior to the 2007-08 crisis – crises focus minds and regular dividends and growth were not the drivers to stewardship that we have seen in recent years!

We support the overall UK regulatory principle of comply or explain. While we endorse the objectives of the Code we would not support moves to introduce a mandatory prescription of this which we consider would inevitably lead to boiler plating and further subcontracting to third parties which leads to our next paragraph:

<u>The use of proxy voting or other voting advisory services</u>

The proxy advisory industry has grown substantially in the last few years and this has at times had a negative impact on issuers. We support a voting process in which fairness of information for all parties is paramount. One of our concerns with the Stewardship Code is the temptation for asset managers to delegate their responsibilities to proxy advisors; that is, to outsource their investor dialogue duties to third parties which typically lack a full or even partial understanding of a company's individual circumstances and make voting recommendations without taking these into account on a one-size-fits-all basis. While the Code itself is not to blame for this practice, the increased delegation of what ought to be investor stewardship carried out by the asset manager has been one unintended consequence of an increased focus on stewardship. Therefore we support the proposed revision in Principle 6 that requests signatories to the Code to explain the extent to which they use, rely and follow recommendations of proxy advisory firms. We would like to see a clear emphasis in the Code of the importance of transparency in the process when investors use proxy advisory agencies and act on their recommendations. We have concerns

regarding the de facto transfer of voting rights from investors to proxy advisors without a corresponding transfer of investor stewardship responsibilities, coupled with a lack of accountability and transparency relating to the proxy advisory agencies, which can have potentially major implications for issuers. It is important for this process that the voting recommendations of proxy advisors are open to scrutiny.

Stock lending

We fully support the proposed revisions on stock lending.

Relevance of signatories' statements

We agree these should be reviewed annually to ensure signatories' statements reflect the evolving Code while continuing to remind them of its objective.

Insider information in the stewardship context

We feel that one area in which there is potential for confusion in the minds of both issuers and investors relates to current initiatives from the FSA for tightening up on wall crossing - regulators have enforced heavy sanctions against those they consider to have misused insider information, especially in wall crossing situations. The recent Greenlight case is the most high-profile example of this and we are finalising a paper for members to offer guidance to our members on inside information, wall-crossing and investor communications. Infringements regarding insider information often centre on whether individuals or companies personally profited (as was the case with Greenlight) and it is essential that conversations between investor and issuer are never 'regulated away', while recognising there are always those who overstep the mark (The Investor Relations Society supports the current regulatory regime and tough stance being taken by the FSA to prosecute market abusers such as insider traders. We believe that shareholders have the right to trade their shares with the knowledge that the markets are operating efficiently and that the price they pay or receive for their shares will not have been distorted by the actions of third parties).

Overall we favour a balanced approach to adding value to both sides of the investor paradigm. We consider the FSA's recent actions have been aimed at stamping down on actual infringements through codifying on-the-record conversations so this is not necessarily contradictory with calls for enhanced stewardship. All parties must remember that a general

discussion between investor and issuer does not automatically mean that price-sensitive information has been transferred!

We therefore support the revisions to Principle 3 that investors should publish their willingness – or otherwise – to become insiders: “Institutional investors who may be willing to become insiders (should) indicate as much in their stewardship statement”. We think a principles based approach is best as it makes allowances for the ‘sounding out’ that has always been part of corporate life, and there is certainly no desire from our members for US style RegFD on this or any other corporate issue.