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the proxy voting agency

Response to FRC Consultation & Paper

Supplementary Explanation of Suggested Amendments to the Stewardship Code

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1 Stewardship and the Code

1.1 Stewardship in Other Asset Classes

The aim of this section is to define Stewardship and its role in investment. We have suggested a number of ways in which the scope of Stewardship within investment could be helpfully expanded, so as to make it a more mainstream concept and underpin the necessary cultural shift to make Stewardship a concept central to investment.

We use the term 'investment' rather than company, so as to better prepare the Code to be able to apply beyond equity, into other asset classes and disciplines, thereby enlarging the scope, applicability and cultural anchoring of the Code throughout investing. We respect the fact that listed equity is the seedbed of many of the concepts (not least because the origins of the Stewardship Code can be traced through the history of the UK Combined Code). As a result it retains statements which are specific to equity investment. Encouraging the use of terms which can be used with a much wider scope at the same time fosters the extension of helpful learning of Stewardship principles, which has thus far largely taken place within equity, to other investment disciplines.

1.2 Fiduciary Responsibility

The essence of stewardship is taking care of something that is not necessarily ones' own. An explicit link to the notion of fiduciary responsibility, one which is erroneous by its absence if we accept that stewardship aims to promote long term success and preservation of investments, underpins the essence of stewardship in the context of the management of investment.

1.3 Stewardship within Equity

A part of enhancing the definition of stewardship within equity is to ensure that capital structures and sustainability issues are included in the concept of what constitutes issues of thematic relevance. Sustainability is a particularly important concept because it captures the full range of 'extra-financial' aspects of corporate life which are important, harnesses a more holistic approach to the cultural embedding of stewardship, yet it is rarely covered by voting.

Another aspect in which the scope of the code should be widened is in terms of the type of asset owner to whom it explicitly applies. We have therefore added Sovereign Wealth Funds and retail investors to the list.

1.4 Voting In Context

Generally, throughout the Code there is an unhelpful over-emphasis on voting to the detriment of engagement and matters important in corporate strategy and performance. Voting should be viewed as an important part of engagement, which is, in itself, a vital tool for the realisation of stewardship aims. However, we do not see voting as a matter of substance *per se* on which investors should engage with companies (though, of course, discussion on how votes may be intended to be cast can and does serve to focus an engagement); rather, we hold that voting should form a part of the ongoing engagement strategy on the chosen matter in question.

2 Application of the Code

2.1 Expand "Service Providers" Beyond Voting

Further to our comments about an over-emphasis on proxy advisors in the investment process, to the detriment of other third party entities who also contribute information to the investment process, we suggest replacing the term "proxy advisor" with "service provider", and "advice" with "services".

Not all service providers offer advice; nor is the provision of advice a pre-requisite for a service provider to be influential in the investment process. If Code signatories are to give a meaningful, holistic account of the role of service providers in assisting with their stewardship activities, then the scope of their statements must be broadened beyond voting. This also facilitates a healthier focus on 'investor decision-making' instead of 'third party advice'.

2.2 Engagement

In respect of approaches to engagement, there is a need for a better balance between disclosures relating to the extent to which an investor may engage individually as well as collectively with others. This may assist with identifying between those investors who are engaging and those who are prone to 'free-ride' by being associated with engagements or investor bodies without significantly contributing to the process. We therefore suggest use of the term "stewardship-driven engagement", to identify engagement, collective or otherwise, which the investor undertakes as a considered step in addressing stewardship aims.

2.3 Explicit Mention of Mandates & Statements of Investment Principles

Since publishing the original Stewardship Code in 2010, the FRC has expressed desire to increase participation in the Code by asset owners. One way in which the link between asset owners and the stewardship activities their third party fund managers undertake on their behalf is by making explicit mention of the tools at the disposal of asset owners in setting expectations in this regard. We therefore suggest making mention of Statements of Investment Principles and individual mandates given to asset managers when discussing ways in which asset owners' adherence to the spirit of the Code may be achieved.

2.4 Description vs. Disclosure

In terms of disclosure, and the quality of disclosure in particular, we suggest it may be more productive for the Code to talk in terms of 'description' rather than 'disclosure' in the context of asset manager reporting of the delivery of stewardship processes. This encourages disclosure which goes beyond the quantitative (which may seem impressive but in fact be relatively meaningless) into the qualitative. This disclosure in turn would encourage asset owners to be more discerning in their expectations of their asset managers.

2.5 Assurance Reporting

Paragraph 9 discusses assurance and quality reporting, Whilst the ICAEW Stewardship Supplement to AAF 01/06 might be a helpful illustration, we would urge the FRC, as a regulator, not to set in stone specific branded or country-specific standards as a 'gold standard', as this may preclude the competitive development and use of more challenging, innovative standards either now or in the future.

It would also facilitate consideration on the part of the asset manager as to what type of assurance reporting is most appropriate for them.

We would recommend that, where assurance reporting is undertaken, the assurance report is made available alongside (or even as a part of) the Stewardship Code statement itself. This would facilitate meaningful evaluation of the Stewardship Code statements.

3 Comply or Explain

In light of encouraging non-UK investors to consider the Stewardship Code, it would be helpful for the document to contain source links for references such as that to the FSA Conduct of Business Rules, to facilitate better overseas access to UK standards and regulations.

This may in turn foster wider adoption of the Stewardship Code by non-resident investors.

4 The Principles of the Code

We have reduced the total number of principles from seven to six. This is largely in order to address the question of over-emphasis on voting, but it also serves as an opportunity to rationalise the remaining six principles.

4.1 Principle 1

Principle 1 has been amended to include capital structure and sustainability as a matter on which monitoring and engagement may be undertaken, as well as to repeat our earlier observation that voting should be seen as a tool within the engagement process.

4.2 Principle 2

Fiduciary responsibility is the back-bone of institutional investment. It is also central to the concept of stewardship, in that stewardship, being the act of managing something on behalf of someone else, implies a responsibility to improve that which is being looked after, for the benefit of the beneficial owner.

Therefore, the institutional investor’s duty to act in the interests of their clients is a fiduciary one. The notion of fiduciary responsibility should be enshrined in the Stewardship Code to give the Code the gravitas it demands and deserves.

4.3 Principle 3

The wording of Principle 3 is amended (for example, by referring to “investments” as opposed to “investee companies”), to prepare the ground for wider application of the Code beyond equity investments. Similarly, “entities” replaces “companies” and “asset” replaces “shares of the company”.

Monitoring of investments is an opportunity to convey expectations not just in terms of financial performance and structures, but also values and culture which are also important in the understanding of an investment and those responsible for it. This also complements provisions in the final Principle relating to asset managers and service providers giving qualitative as well as quantitative information to their clients.

We have also amended some of the aspects to be monitored to specifically include values as well as valuation, to underline the importance of the former in arriving at a more nuanced approach to the latter. Again, this is to have the effect of encouraging investors to consider investments beyond the balance sheet and formal statements. It would also serve to foster the use and development of research on sustainable investment issues which so often strike at the heart of corporate values.

References to "adhering to the spirit of relevant Codes" have been included so as to give an opportunity for the UK Stewardship Code to be more easily seen as a blueprint for similar initiatives elsewhere.

Monitoring of investments is requisite for the early identification of opportunities and problems. We have therefore included a paragraph to set out the dependency upon effective monitoring of the ability to identify opportunities and problems at an early stage. This also then links to the following Principles which set out follow-up activity (including engagement).

It is clear that there is a great deal of confusion and uncertainty as to who is or is not "influential" in the stewardship process and clarity of roles and responsibilities would, we believe, be welcomed. We have therefore included in the guidance under Principle 3 an amended section from the provision on proxy voting in the existing Code. This is designed to encourage meaningful reporting of the contribution external service providers make to the signatory's investment processes. This places a more positive emphasis on the importance of service providers in their role as information gatherers and decision support tools, rather than portraying them as drivers of decisions as is the case in the previous version of the Code.

4.4 Principle 4

Principle 4 is amended to refer to "investor value" instead of "shareholder value", again to prepare the ground for wider application of the Code beyond equity investments.

We suggest that Principle 4 disclosures should make an explicit link between policy guidelines on when and how activities will be undertaken and the overall aims of the stewardship strategy.

4.5 Principle 5

Principle 5 has been amended to promote a wider, more balanced conceptualisation of engagement.

Firstly, we have made suggested amendments to make clearer the references to solo as well as collective engagement, and the role of voting as a part of the engagement toolbox. Whilst collective engagement is a valuable tool, investors should not discount the possibility of solo engagement, where appropriate. This enables the individual institutional investor to ensure the ability to press home their own views on issues where they feel it is important to do so, and is a vital component of the carrying out of fiduciary responsibility where underlying customer views may be specific or diverse. Establishing a policy on when and how solo and collective engagement is undertaken will also help investors take a holistic approach to stewardship activity.

Secondly, it is important to understand engagement as more than something which is undertaken to address a problem, and not something which we should wait until times of economic stress to employ. The immediate public opinion context of the first version of the Stewardship Code was that institutional investors especially might have been able to achieve more in terms of prevention if they had been more pro-active in their identification and management of potential risks within the financial sector. The FRC has an opportunity here to establish positive engagement as a means of enhancing value, in addition to the problem resolution aspect which is more often referred to.

We develop further the question of voting being a part of a wider engagement strategy by establishing the notion that consideration should be given to whether voting contributes to the aims of the stewardship strategy at all. This goes beyond simple cost-benefit considerations.

It is also important to not be too prescriptive of the way in which votes may be used in the event that a satisfactory outcome to an engagement cannot be achieved – the important effect is that investors should consider using their votes to oppose management.

Finally, in the context of the largest section on direct communication between investors and companies, identification is vital. This is an ideal opportunity for the FRC to draw attention to the importance of nominee ownership arrangements and the effect this can have on legal certainty of voting processes and the general ability to identify oneself as a shareholder when shares are held through an intermediary.

4.6 Principle 6

New Principle 6 (Principle 7 in the FRC's document) has been amended to widen references which refer rather too specifically to "engagement and voting" by replacing with the term "stewardship activity". By applying the meanings of the previous provisions, this can then be taken to mean that monitoring of and formal accountability for activity under the Stewardship Code should encompass the processes and use of resources employed in the full range of activities, (e.g. including monitoring of investments) rather than just accounting for engagement and voting.

We have again deleted references to specific assurance frameworks, for reasons already mentioned above.

Reporting of Stewardship in its wider senses should enhance the scope of the concept of Stewardship and foster a cultural shift towards greater mainstream acceptance of stewardship principles across the investment industry.

5 Concluding Remarks

We recognise that we have made a number of potentially significant suggestions with some profound implications for the Stewardship Code and how it might be viewed and used. We would of course be happy to engage with the FRC to explore any of the above in more detail.

The essence of our views is distilled from two themes:

- Fiduciary responsibility and
- Sustainability

The importance and relevance of fiduciary responsibility is to establish a robust context within which Stewardship should be viewed, and to help foreign investors understand a set of bets practice provisions nevertheless remain cast within a 'comply or explain' framework.

The inclusion of sustainability as a relevant Stewardship theme widens the scope of Stewardship from the corporate governance context from which it has emerged, to capture a much fuller potential in relation to promoting a healthier economy, greater breadth of important qualitative considerations. It is also a highly important consideration in the current debate about corporate culture, in setting a robust moral compass with which financial markets may be able to re-establish trust.

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