Governance for Owners

Chris Hodge
Financial Reporting Council
Fifth Floor
Aldwych House
71-91 Aldwych
London WC2B 4HN

codereview@frc.org.uk

13 July 2012

Dear Mr Hodge

Financial Reporting Council Consultation on Revisions to the UK Stewardship Code

Thank you for the opportunity to submit comments in relation to the UK Stewardship Code. By way of background, and to put our comments in context, Governance for Owners (GO) is an independent partnership dedicated to adding long-term value to clients' equity holdings through relational investing and active share ownership.

We welcome the move by the Financial Reporting Council to strengthen the UK Stewardship Code, in particular greater clarity on the delineation of responsibilities between asset owners and asset managers, disclosure by institutional investors on their approach to stock lending and recalling lent stock, and strengthened language on independent verification of asset managers' engagement and voting processes.

At the same time, we remain concerned about several matters. First, we worry that some key impediments to effective stewardship – such as the lack of congruence between the performance metrics/financial incentives for asset managers and the stewardship responsibilities expected of them – continue to be unaddressed. Second, the Code's provision on conflicts of interest is, in our view, still relatively weak. Third, we believe it would be helpful to provide further guidance on how asset owners should monitor the application of the Stewardship Code by their asset managers.

Stewardship and the Code

We welcome the new introduction to the UK Stewardship Code. We agree that the objective of stewardship activities is to "promote the long-term success of companies so that the ultimate providers of capital also prosper" and that stewardship responsibilities are shared between the board and investors.

We believe it makes great sense to disaggregate "institutional investors" into asset owners and asset owners and to state explicitly that they have different sets of responsibilities. We particularly support the emphasis in the revised Code that asset owners, as providers of capital, "set the tone for stewardship and may influence behavioural changes that lead to better stewardship by asset managers and companies."

We believe decision-making on "institutional investors' activities" should also include ensuring alignment of the performance metrics and financial incentives of asset managers with the stewardship responsibilities expected of them (as set forth in the investment management agreement and other documents). It is well-known that misalignments in this area have contributed to stewardship behaviours of many asset managers falling short of expectations. To narrow the stewardship deficit, we proposed in our response to the 2010 Stewardship Code consultation that mechanisms be devised to reward asset managers who are good stewards – possibilities deserving of consideration include enhanced dividends, extra voting rights, and long-term tax benefits.

Application of the Code

We very much agree that the Stewardship Code should extend to service providers, such as proxy advisors, investment consultants, and other relevant parties involved in voting, engagement, and other stewardship-related activities.

We believe further guidance should be provided to asset owners – either in this section or elsewhere in the Code – on good practices they can employ to hold asset managers and other service providers accountable for their stewardship activities. For example, we feel it is quite important for asset owners to meet with their asset managers in person at least annually to review stewardship-related activities – face-to-face discussions would enable asset owners to obtain further details on engagement and other matters.

We very much agree that asset managers should explain which of their equity funds or products are covered by their statement on stewardship approach. In this regard, we would like to draw your attention to the work of the Investor Stewardship Working Party[1] (ISWP), which published a set of recommendations – one of which is the attached Stewardship Framework – earlier this year on ways to improve investor stewardship.

A key finding of the ISWP is that there is a shortage of information on the amount and quality of stewardship that asset managers offer. At many investment firms, information disclosed publicly and to clients on their stewardship approaches is worded in general terms, thereby making it extremely difficult to distinguish one asset manager from another. Consequently, the ISWP developed the Stewardship Framework to help asset owners and quoted companies to differentiate asset managers along the following dimensions of stewardship:

- Voting

[1] The Investor Stewardship Working Party comprises Aviva Investors, BlackRock, Governance for Owners, Ram Trust, RPMI Railpen, and Universities Superannuation Scheme, with the support of Tomorrow's Company. Its report, *2020 Stewardship*, is available at http://www.forceforgood.com/Uploaded_Content/tool/2132012172742724.pdf.

- Engagement
- Policy activities
- Integration
- Reporting to clients
- Compensation/incentives for investment staff
- Conflicts of interest
- Public transparency

The ISWP acknowledges that the Stewardship Framework will need to be refined in order to be fully operational and invites interested institutions to contribute to its effective implementation.

In addition, we support the call for institutional investors to disclose whether they adopt a stewardship approach to other asset classes in which they invest.

Comply or Explain

We are in agreement with the overall tone and substance of this section of the Code.

The UK Stewardship Code

We are concerned that *Principle 2* on managing conflicts of interest continues to be insufficiently robust. As we pointed out in our submission to the 2010 Stewardship Code consultation, conflicts of interest are pervasive in the investment management industry. We therefore reiterate our previous suggestion that the Stewardship Code require institutional investors to take steps to avoid situations where conflicts of interest arise.

With respect to *Principle 3*, we would like to see a stronger emphasis on the importance of regular, on-going dialogue between companies and their shareholders, particularly long-term institutional investors (including, but not limited to, index funds). We believe regularity of engagement is critical to building mutual trust, which can pay substantial dividends when a serious problem arises.

More broadly, we believe that the quality of engagement between companies and investors can improve. According to the company chairmen, CEOs, and company secretaries that the ISWP interviewed earlier this year, a substantial proportion of meetings with shareholders are unproductive. In particular, they lamented the poor understanding of many investors on such matters as the company's strategy, value drivers, and human dynamics within the firm. To improve the quality of discussions, the ISWP is facilitating the development of a guide to good engagement practices.

We are pleased to see in *Principle 4* the extension of risk factors to all material risks. Similarly, we agree with the clarification in *Principle 5* that institutional investors should disclose the circumstances in which they would participate in collective engagement.

In *Principle 6*, we agree that institutional investors should disclose how they utilise proxy voting research and other voting advisory services. We are also highly supportive of the new language pertaining to the disclosure by Code signatories' of their approach to stock lending and recalling lent stock.

With respect to *Principle 7*, we elucidated in our 2010 consultation response that asset managers should detail in their reports information that would give insights on the *quality* of voting and engagement activities, for example:

- Resources allocated to voting and engagement activities, including the experience and expertise of voting/engagement personnel and the involvement of fund managers and senior executives

- Key objectives and initiatives pursued during the period in question

- Significant developments and issues encountered during the preceding period, including successful and unsuccessful interventions and explanation of differences in outcomes

- The extent to which voting and engagement activities have been integrated into the investment process and have impacted investment decisions

- The extent to which the level of resources allocated and activities undertaken meet client expectations as specified in investment management agreements

We agree with the FRC that excessive details on individual company engagements may be counterproductive in that boards may become less candid with their investors.

In addition, we would suggest that disclosures under *Principle 7* include the number of lent stocks recalled during each reporting period. Lastly, we support the strengthening of the Code provision relating to independent verification of asset managers' engagement and voting processes.

We hope you find these comments helpful. Please contact us if you would like to discuss any of the points made above.

Yours sincerely,

Peter Butler	Simon Wong
Chief Executive and Founding Partner	Partner

Appendix: Stewardship Framework on Equities for Asset Managers

Description

It is envisaged that asset managers that have signed up to the Stewardship Code will be required under Principle 1 to disclose their approach to stewardship within a generally agreed matrix framework, as per criteria below. Explanations (with supporting evidence) must be provided on the asset manager's website. In time, it is anticipated that a public statement on activities will be audited under AAF 01/06. Over time, clients may require this by products or by groupings of similar products.

Category	Full Range of Stewardship Activities / (Approach A)	Some Stewardship Activities / (Approach B)	Limited Stewardship Activities / (Approach C)	Exemptions/Further Explanation
Voting	Votes at least 90% of portfolio holdings	Votes less than 90% but greater than 60% of portfolio holdings	Votes less than 60% of portfolio holdings	Does not vote portfolio holdings due to investment approach (e.g., short-term fund), firm size (less than £1bn AUM firm-wide), type of securities (e.g., synthetic ETFs, non-voting shares) or client instructions (for segregated mandates)
Engagement	Engages proactively on a full-spectrum of topics (ESG, strategy, performance, financials)	Engages principally on a reactive basis and on a limited range of topics	Does not engage or rarely engages with investee companies on ESG matters	Does not engage with investee companies due to investment approach (e.g., short-term funds), firm size (less than £1bn AUM firm-wide) or client instructions (for segregated mandates).
Policy activities	Actively contributes to key policy debates on stewardship in all relevant geographies	Contributes to selected policy debates on stewardship in some geographic regions	Rarely or does not contribute to policy debates on stewardship	Does not contribute to policy debates on stewardship due to investment approach (e.g., short-term fund) or firm size (less than £1bn AUM firm-wide)
Integration	Full integration between the investment and CG/ESG teams on voting, engagement and policy activities. Integration into index funds/products in accordance with the investment strategy.	Some collaboration between the investment and CG/ESG teams on voting, engagement and policy activities	Rare or no collaboration between the investment and CG/ESG teams on voting, engagement and policy activities	Investment and CG/ESG teams not integrated due to investment approach (e.g., quant funds or index funds)
Reporting to clients	Detailed written reports on stewardship activities to clients and in-person meetings (or equivalent) with clients to discuss stewardship activities at least annually	Detailed written reports on stewardship activities to clients	Summary reporting of stewardship activities	
Compensation/ incentives for investment staff	Compensation for investment staff based on at least 3-year portfolio or firm performance	Compensation for investment staff based on at least 2-year portfolio or firm performance	Compensation for investment staff based on less than 2-year portfolio or firm performance	
Conflicts of interest	There are no, or immaterial, conflicts of interest, or conflicts are fully mitigated.	There is an active effort to avoid and mitigate conflicts of interest	There are unresolved/unresolvable material conflicts of interest	
Public transparency*	Comprehensive and detailed disclosure on website of stewardship policy, approaches and activities and other relevant matters to investee companies, clients and the public	Moderately extensive disclosure on website of stewardship policy, approaches and activities to investee companies, clients and the public	Summary disclosure on website of stewardship policy, approaches and activities to investee companies, clients and the public	
Qualification thresholds	***A manager qualifies under this category if at least 6 out of 8 of the above criteria are rated as Full Range of Stewardship Activities (one of which must be Engagement) and there is no Limited Stewardship Activities rating.***	***A manager qualifies under this category if at least 6 out of 8 of the above criteria are rated as Full Range or Some Stewardship Activities (one of which must be Engagement).***	***A manager qualifies under this category if it does not qualify under any other category.***	***A manager qualifies under this category if it meets at least 3 out of 4 of the above criteria. Otherwise, it will be classified as either Full, Some or Limited. A firm falling under this category can elect to self-categorise (in which case it must meet the same standards as a non-exempt firm or product).***

* Extensive and full discussion of the quantum and quality of stewardship, including the following (non-exhaustive): Policy on engaging investee companies (e.g. holding thresholds, types of issues, key contacts); resources allocated to stewardship activities; engagement approaches (including escalation policy and methods/frequency of collaboration); meetings held with investee companies and other interested parties; successful and unsuccessful engagements; integration of stewardship activities in portfolio management; avoidance, mitigation and management of conflicts of interest; compensation structure of investment staff and other relevant personnel; key internal decision-making processes and organs on stewardship matters; etc. Asset managers should strive for a level of clarity that would enable 1) investee companies to understand (ex-ante) when, on which topics, and with whom they can engage on stewardship matters and 2) clients to distinguish different equity products on the key dimensions of stewardship.