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BUSINESS UNIVERSITEIT

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Direct dial number : + 31 346 291 417
Subject : **Stewardship Code Comment**

Dear Sirs

It is with the utmost modesty that we, foreigners, take the liberty of proposing some minor changes to the Stewardship Code.

We do so based on some theoretical considerations on the one hand and empirical research by the Nyenrode Corporate Governance Institute into shareholders' engagement in the Netherlands in 2010, 2011[1] and 2012 (forthcoming) on the other hand.

We investigated institutional investors' compliance with the Dutch Corporate Governance Code and their stewardship behavior towards Dutch listed companies. Shares of Dutch listed companies are primarily owned and managed by foreign institutional investors. For our research 25 Dutch asset owners (pension funds, insurance companies and investment companies) and asset managers, as well as 14 foreign asset managers (most of them signatories to the UK Stewardship Code) were surveyed and interviewed. In our research many references were made by our respondents towards the UK Stewardship Code and the findings night therefore be helpful in an improved and more consistent understanding of stewardship as laid down in the Code.

Conceptual model

We believe that if the concept of stewardship is to succeed in practice, it must be more solidly anchored in theory. Therefore, we have focused our theoretical comments on the introductory section – "Stewardship and the Code."

That section (2) states that the board and investors share responsibility for stewardship. We consider the phrasing of this statement to be less than crystal clear as well as potentially dangerous. Shared responsibility makes accountability disappear and, going back all the way to Cadbury, accountability is what corporate governance is about.

[1] http://commissiecorporategovernance.nl/page/downloads/2010_Onderzoeksrapport_Aandeelhouders.pdf; http://commissiecorporategovernance.nl/page/downloads/2011_Aandeelhoudersbetrokkenheid_in_Nederland_2011.pdf

Because the aim of the Stewardship code is to improve the behaviour of institutional investors in their role as shareholders, it must be made very clear just how institutional investors can be held accountable for good stewardship. In order to do this, we think it is important to recognize two separate agency relations.

The first is within the firm, where, in most corporate governance literature, the board is considered the agent of the shareholders. Failure by shareholders to fulfil their part of this agency relation has been discussed since Berle & Means noticed the separation of control and ownership at the largest US corporations almost a century ago. In this agency relation, institutional investors, owners of most shares in listed companies, are principals. And the is principal is not accountable. A principal is almost sovereign in his actions, limited only by the law. An agent, however, has clearly described fiduciary duties towards his own principals.

That's were the second agency relation comes in. This second agency relation is the one between institutional investors and their own beneficiaries. In this relationship the institutional investor is the agent. And in this relationship, the institutional investor can be held accountable for his actions, including his actions as a shareholder.

We suggest, as a matter of sound reasoning, that the Stewardship Code address institutional investors not as principals, but as agents. In other words, an institutional investor should not be assessed in his capacity as a shareholder, but in his capacity as the guardian of other people's money.

In our view the approach of the Stewardship Code should be, "How is an institutional investor accountable to his own beneficiaries/clients for the way he exercises his duties as a shareholder on their behalf?"

This thought might be explicitly added to the preamble of the Code, for example, as a third part of the first introductory section. This approach should also be clearly stated in the principles.

In the present text, principle 3 (monitor) addresses the institutional investor as a principal. And, as is indicated by the formulation of the guidance giving tasks such as 'seek to keep abreast', 'seek to satisfy themselves', 'seek to consider' and to attend General Meetings 'where appropriate and practical', principals cannot easily be steered. These are not the types of clear commands needed to ensure that the agent does what the principal wants.

Principle 4 (escalation guidelines) addresses the institutional investor neither as an agent, nor as a principal and, for that reason, seems superfluous. It might be based on thoughts about the responsibility an investor has to the (board of the) company, but we think it wiser to keep discussions about such concepts out of the Code.

Just as in the first agency relation a company's board is primarily accountable to shareholders for the investments made by the company, in the second agency relation the institutional investor should be accountable for its investment decisions on an individual company level.

Only such disclosure on an individual investment level gives beneficiaries/clients the information to judge the qualities of the institutional investor. It will also offer the beneficiary/client the information to decide for himself whether he thinks engagement is necessary.

We think it of paradigm importance to explain to the public at large the two agency relations that are relevant for stewardship: one between company and shareholder, the other between institutional investor and beneficiary/client. Unless it is clear that investors are agents engaging other agents, stewardship will not bring forth the fruits of governance.

<u>Practical findings</u>

In our research among institutional holders of Dutch shares we found that at present beneficiaries are completely left out of the picture, as the following quotes from institutions may confirm:

> ‗…*We vote and engage to the extent that the issues will impact us in that they will impact the stock price. (…) But, and again, a lot of our holdings could be in the quantitative aspect, where, in the quantitative area of our business they do not engage at all.*'

> ‗…*We only engage directly where we believe we can influence the outcome. When we don't believe we can influence the outcome, we don't engage.*'

> ‗…*We couldn't compare ourselves to companies where engagement comes first. We have a risk return focus approach. Our focus is not about engagement. From engagement perspective, we try to influence management behavior only where we think there is an effect. Engagement is more exception to the rule than it is the rule.*'

> ‗…*We do engage with companies [..], we select […] engagements, according to our own strategies and focus areas, that will be on a global basis. We will take into account the size of the company, the company's size in the portfolio, the performance of the company and the performance of the company towards the expectations that we have as a shareholder.*

> ‗…*we are long term managers. We want to buy good companies. Our analysts meet with managers, they have a dialogue, over time, they engage when they feel it is relevant to the long term value of the company.*'

> ‗…*We are an active manager, overweighing index companies that we think will outperform and under weighing the opposite ones. I think that is a pretty important consideration in terms of how willing we are to engage. Like anyone else we make resource prioritizations. It is the size of the holding, likelihood of success, all in the context of what I call a generalized cost-benefit analysis.*'

> ‗…*Being so passive, the only touch point to influence the value of your underlying investment, is through the governance process. You can not buy or sell the security or have interaction with the management if you simply hold them passively. Because to the extent they are either weighted in the index or get out or dropped out, you are going to track that.*

So governance is really the only touch point and because of that we assign a certain level of value to that, which we think is fairly high, with that you have to carry out this kind of process.'

‗…We always make use of voting rights and always have a dialogue with the company.'

‗…A substantial part of our [total] costs is devoted to active engagement with the companies in which we invest. And it is an expensive business. Therefore, an issue many large institutional investors face, is when they own a large portfolio it is difficult to engage actively with a large number of stocks given the expense of the operation. That is to some extent a commercial opportunity for us, because we work with those institutions and help them. Some of the larger organizations that can afford to fund big governance teams will undertake to engage actively, but in many cases it is more effective and efficient to outsource it to people like ourselves.'

‗…We never have a role [only] on behalf of other institutional investors. Only if we own a share in the company, we may well wish to represent the interest of other shareholders. We like to be visible. Being at the front of the pack.'

‗…Engagement is core to our business, it is what we do, it is what we promise our clients. This is what they pay us to do, and to do it properly. Secondly, we truly believe that helping companies in these issues, talking to companies about these issues, will help create sustainable value. So we do link what we are doing to value creation, and this is the whole universal owner argument.

‗…There is a link between liquidity of investment style and propensity to engage. Those investors investing in illiquid strategies, perhaps in smaller companies or emerging markets, taking larger stakes difficult to sell, they are going to be more interested in good ownership because it makes sense with the derivate. […] the answer for the resource problem is the pooling of resources at the asset owner level.

Obviously at the moment it is the institutional who shapes the engagement policy. The ultimate beneficiary is not consulted. In our view this second agency problem has to be addressed before we can hope to improve the first agency, that between company boards and their (institutional) shareholders.

We hope these comments are helpful in addressing the difficult issue of making sure that institutional investors act as good shareholders in public companies. We emphasize our belief that only when they are addressed as agents will institutional investors be guided to do what is in the best interest of their beneficiaries.

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