FairPensions™

The campaign for **responsible** investment

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FairPensions Response to Consultation: 'Revisions to the UK Stewardship Code', July 2012

FairPensions welcomes this opportunity to comment on the draft revised UK Stewardship Code. The proposed changes reflect a number of positive developments which clarify the scope and application of the Code. In particular, we welcome:

- the clarification of the Code's requirements re. voting disclosure (see section 4 below);
- the reference to overseas equities: as indicated in our response to the 2010 consultation on the original Code, in our view this is vital to protecting beneficiaries' interests;
- the clarification that the Code extends to service providers such as consultants and proxy advisors (providers of engagement overlay and ESG research services could also be encouraged to sign up to the Code);
- the reference to stock lending;
- the reference to other asset classes;
- the reference to speaking at company General Meetings; and
- the requirement that policies should be reviewed annually and updated where necessary.

Below we provide detailed comment on a number of issues in which we have a particular interest. Where relevant we have used the headings given in the consultation document for ease of reference. Where possible, we have also illustrated key proposed changes on a marked-up version of the Code (appended): our response should be read in conjunction with that document.

In our view, the proposed changes meet the FRC's tests for amendments to the Code, in that they aim to assist understanding of stewardship and the Code whilst avoiding undue prescription. The proposed changes have no significant effect on the length of the Code, in line with the FRC's desire to avoid "*add[ing] unnecessarily to the level of detail*".

1. The definition of stewardship

We strongly agree that the Code would benefit from greater clarity about what 'stewardship' means and welcome the FRC's efforts to address this. The proposed wording is a good starting point but we believe that it could be improved in several respects.

Defining 'stewardship'

Firstly, although the new section 'Stewardship and the Code' offers helpful insight into the principles underlying the Code, it still does not define the term 'stewardship' itself. Instead

the first paragraph begins, “Stewardship activities aim to promote…”, which may suggest to the reader that the document assumes a tacit common understanding of what the word ‘stewardship’ means in the first place.

Far from being an unnecessary theoretical distraction, we believe that going back to first principles is fundamental to resolving the current confusion. For instance, there is often a lack of clarity regarding whom ‘stewardship’ obligations are owed to, with some people appearing to regard them as a reciprocal duty to companies in exchange for shareholder rights, and others viewing them as a responsibility to beneficiaries. In our view, from a legal perspective the latter must be correct, since institutional investors’ fiduciary duties are owed exclusively to their beneficiaries: investors have no duties to companies themselves. Being clear on this also helps to underpin the appropriateness of applying the Code to overseas equities, since this is just as important for protecting beneficiaries' financial interests as UK equities.

By extension, we have also encountered confusion and differences of opinion as to what is being ‘stewarded’: are investors stewarding companies? Their beneficiaries’ assets? The environment? In our view, a full understanding of good stewardship encompasses all of these. Indeed, the draft Code employs multiple meanings, for instance in ‘Application of the Code’ (para 7), which states “*Asset owners should seek to hold their managers to account for their stewardship activities. In so doing, asset owners better fulfil their duty to their beneficiaries to exercise stewardship over their assets*.” However, the FRC needs to articulate a coherent definition which ties together these disparate notions of stewardship and is clear about the relationship between them.

To illustrate, building on our response to the 2010 consultation on the original Code, we would suggest the following as a possible form of words:

> *“Stewardship is the act of looking after something on behalf of someone else. Institutional investors are entrusted with the stewardship of assets which ultimately belong to their beneficiaries or clients. Fulfilling this responsibility requires them to be good stewards of the companies in which those assets are invested, with a view to ensuring (i) that those companies have business models which are capable of delivering long-term shareholder value through sustainable wealth creation, and (ii) that such business models are being effectively implemented. The principle means by which this responsibility is discharged is engagement with boards and/or management to ensure that they too, in turn, are acting as effective stewards of the company.”*

Fiduciary duty

The notion of stewardship as the act of looking after something on behalf of another is closely allied to the notion of fiduciary duty. We suggest that it would be helpful for the FRC to make explicit reference to this, and to note that adherence to the Code may help institutional investors to fulfil their fiduciary duty to protect beneficiaries' interests. This would help to combat the perception in some quarters that applying the Code is incompatible with the discharge of investors' fiduciary duties.

The confusion with 'socially responsible investing'

We sympathise with the FRC's concern about the tendency to identify stewardship with 'socially responsible investing'. Clearly, the aim of stewardship is to enhance long-term value, and it is therefore separate from ethically-motivated investment approaches such as negative screening. However, there *is* a genuine relationship between stewardship and more mainstream 'Responsible Investment' approaches: it is no accident that industry

players with a strong RI reputation have been among the early champions of the stewardship agenda. In some ways, RI is a subset of stewardship: if stewardship involves engaging with investee companies to enhance long-term value, RI involves engaging with investee companies *on environmental and social issues* to enhance long-term value. We would suggest that a definition which articulates this relationship explicitly, emphasising that stewardship is (a) principally financially-motivated and (b) includes but is certainly not limited to engagement on environmental and social risks, would help to tackle this confusion head-on.

In the interests of consistency, we would also suggest that the wording of paragraph 4 should be amended in line with the parallel wording in the guidance to Principle 4 regarding possible grounds for intervention (*"the company's strategy, performance, governance, remuneration or risks, including those that may arise from social and environmental matters.")*

Systemic risk and the wider economy

Recent events have also re-emphasised the interest of institutional investors, as 'universal owners', in the health of the wider economy and financial system. Clearly, it is not in the interests of institutional investors for major banks to manipulate LIBOR, even if such manipulation benefits the individual firms concerned. In many ways this brings us full circle to the reason for the Code's introduction post-financial-crisis. The Treasury Select Committee is currently considering the role of corporate governance and shareholder engagement in mitigating the systemic risks posed by major financial institutions. In this context, it might be helpful for the introduction to the Code to explicitly acknowledge the interest of most institutional investors in the wider economy, and the role of good stewardship in addressing systemic risks posed by individual firms.

2. The roles of asset owners and asset managers

We welcome the FRC's efforts to differentiate more between the respective roles of asset owners and asset managers. In our view this is vital to improving the effectiveness of the Code. However, we are unclear as to what is meant by the idea of a 'spectrum' between asset ownership and asset management. In our view, the terms 'asset owner' and 'asset manager' represent a reasonably clear binary distinction – the complication is that some institutions, as the consultation document notes, *"may simultaneously engage in activities associated with both"* (for instance, large pension funds with an in-house asset management function, or fiduciary managers). We are not convinced that a 'spectrum' is the right way to articulate this nuance – there is a danger that this could add to confusion on this point rather than clarifying the position. In our view it would be clearer to invite signatories to consider and indicate whether they are signing primarily as an asset owner, an asset manager, or both.

It should also be made clear that, where large asset owners such as insurance companies have internal asset management arms, it is best practice to distinguish between these two roles for the purposes of the Code. This would help overcome the situation encountered by our recent survey whereby many insurance companies rely on the stewardship policies of their internal asset management arms, and do not see the need to become signatories to the Code in their own right as asset owners.

Moving on from the preamble to the text of the Code itself, there may yet be scope for greater clarity about the respective roles of asset owners and asset managers in practice. For instance, the guidance to Principle 1 states only that the stewardship responsibilities of

asset owners *“may be different”* from those of asset managers, without indicating how this may be the case. This is covered to some extent in ‘Stewardship and the Code’ (para 6) and in ‘Application of the Code’ (para 7), but this scattered approach may not give the clarity the FRC wishes to provide.

In addition, paragraph 7 could itself be clearer about the particular issues asset owners will need to consider when developing their approach to stewardship. For instance, some asset owners will have detailed in-house positions on issues such as remuneration or sustainability, and will instruct their managers accordingly; they may also retain the right to instruct managers how to vote in particular cases. Others, particularly smaller asset owners, will rely to a greater or lesser extent on the stewardship policies of their asset managers.

We agree that mandates are vital in transmitting asset owners’ preferences regarding stewardship along the chain to asset managers. The reference to ‘mandates’ could be amended to clarify that this refers both to the selection of managers and to the terms of the mandates awarded. Regarding the latter, it should be acknowledged that asset managers also currently have a role in shaping mandates, both individually in negotiations with clients, and collectively through the guidance produced by organisations such as the ICGN and IMA.

We welcome the confirmation in this paragraph that *“asset owners should seek to hold their managers to account for their stewardship activities”*. In our view, this is a key stewardship function of asset owners. As part of redressing the balance between the roles of asset managers and asset owners in the Code itself, it might be helpful to transplant this wording into the guidance to Principle 7.

More generally, where efforts have been made to differentiate between asset owners and asset managers in the guidance, it is not always obvious or explicit what is intended to apply to which signatories. There might be value in signposting this explicitly within the guidance, in particular so that asset owners can see ‘at a glance’ which elements of the guidance are specifically applicable to their role. The introductory sections could also define the terminology used in the Code (for instance ‘clients’ and ‘beneficiaries’) and the actors to whom it is intended to apply.

3. Conflicts of interest

We are very pleased that the FRC has identified conflicts of interest policies as an area for improvement and is seeking to address this in the revised Code. As the FRC is aware, our own research has also raised concerns on this front.[1] However, we are unconvinced that the proposed changes will fully address these shared concerns.

On the question of whether policies should be ‘robust’ or ‘effective’, we have no view, except to say that some such terminology must be included: it would be unacceptable for this to be removed or watered down (for instance to refer to an 'appropriate' policy, or simply 'a policy'). As the consultation document notes, the word 'effective' would be consistent with FSA rules. However, as the consultation document notes, it is questionable whether tweaking this wording will resolve the underlying complaint that it is unclear what this standard requires and difficult to demonstrate whether it has been complied with.

[1] FairPensions, 2010, ‘Stewardship in the Spotlight’, http://www.fairpensions.org.uk/research

The proposed revisions to the guidance go some way towards addressing this problem and we welcome these changes. However, based on our research, the problem with many conflicts policies was not solely that they did not state an intention to put clients' interests first, but that they failed to demonstrate *how* the firm proposed to achieve this, and in *what* circumstances significant conflicts might arise. We find it difficult to see how a firm could demonstrate that their conflicts policy was 'effective' without this.

Different signatories to the Code are subject to different potential conflicts: some may trade in the shares of a parent plc, while others may not; some may be part of a group which contains an investment banking arm, while others may not; some may have board members with directorships in listed companies, while others may not. The users of conflicts policies are unlikely to have an in-depth understanding of the particular conflicts arising from the firm's business model: indeed, part of the purpose of a conflicts policy is to give them that understanding. As such, a conflicts policy expressed entirely in general terms can give little insight to prospective clients on the effectiveness of a firm's procedures for ensuring that conflicts do not compromise effective stewardship. Readers cannot judge the 'effectiveness' of a policy for managing conflicts if the policy gives no indication of what those conflicts are or how they are being managed.

We would therefore suggest that the following wording be added to the guidance:

"The policy should indicate any particularly significant potential conflicts which may arise in relation to stewardship, and should outline the process in place to ensure that such conflicts do not prejudice the interests of clients or beneficiaries."

We do not feel that this amounts to 'undue prescription'. Signatories retain complete flexibility to decide how much detail to provide and what constitutes a 'significant' conflict: there would be no requirement to produce an exhaustive list of all potential conflicts. For instance, if external directorships are identified as a potential source of conflict, the policy would not be expected to list every directorship held, but simply to highlight the issue in general terms and outline the process in place for ensuring that such directorships do not compromise engagement with the companies concerned. Indeed, in terms of the degree of detail this is comparable to the proposed new guidance to Principle 6, which requires signatories to state *"the kinds of circumstances in which the institutional investor would consider participating in collective engagement."* We would suggest that meaningful insight into how key potential conflicts are managed is at least as important to the users of signatories' reports as an understanding of their approach to collective engagement.

An example of current best practice which we believe would meet the spirit of our proposed new guidance is Aviva Investors' stewardship statement. Clearly, a key potential conflict for a firm such as Aviva is the potential for the interests of Aviva Investors' clients to differ from those of Aviva plc. After Aviva's remuneration report was defeated this year, some corporate governance commentators began speculating as to how Aviva Investors had voted their own clients' shares. This speculation was immediately resolved by reference to Aviva Investors' stewardship statement, which specifically dealt with their (commendably robust) procedure for voting shares in Aviva plc. This is the function which conflicts of interest policies should fulfil, and we believe that the additional wording we propose would help significantly to ensure that this is achieved.

4. Voting disclosure

We welcome the change to the guidance to Principle 6 which removes the ambiguity regarding voting disclosure. As we have previously noted, this ambiguity has led to confusion regarding the proportion of signatories complying with Principle 6, since the previous wording was widely interpreted as suggesting that signatories would be compliant as long as they explained why they did not disclose. Clarifying this point is a welcome step and is consistent with government policy: the Secretary of State for Business, Innovation and Skills[2] and his junior ministers in both the Commons[3] and the Lords[4] have confirmed on numerous occasions that the government believes all institutional investors should publicly disclose their voting records.

We hope that the FRC will take steps to ensure that the clarificatory intent of this change is understood and noted by signatories, as it may otherwise pass 'under the radar'.

The practical impact of this change may also be affected by the degree of clarity the revised Code provides as to the status of the guidance. While the section 'Application of the Code', like the original Code, states that *"the FRC expects [stewardship statements] to disclose the specific information requested in the guidance"*, the section 'Comply or explain' states that the guidance *"recommends how the principle might be applied"* (our emphasis). This could lead some to remain of the view that it is possible to claim full compliance with the Code without disclosing information, such as voting records, referred to only in the guidance. Replacing the word "might" with "should" would be clearer in this respect. If this is felt to be inappropriate, or if confusion persists following the issuing of the revised Code, the FRC should consider elevating the requirement to disclose votes into the wording of Principle 6 itself.

Finally, we refer to our 2010 submission, which suggested that it would be helpful for the FRC to provide a voluntary template for disclosure.[5] We understand the FRC's desire to avoid an unnecessary proliferation of guidance. However, such a template should reduce the burden of disclosure on firms, since they would not have to devise their own method and form of reporting. Voting disclosure is meaningfully different from disclosures on stewardship practices or conflicts management, since it consists of factual data rather than qualitative policies – 'boiler-plating' is therefore not a concern. In our view, the case for some kind of template has been made stronger since the introduction of the Code by the wide variation in disclosures – for instance, our own and others' research has found that many signatories disclose only summary statistics, which give no insight into how individual votes were cast.[6] A common standard would help ensure that disclosures meet their twin objectives of facilitating comparisons by clients and prospective clients, and guaranteeing transparency and accountability to beneficiaries.

[2] Commons Hansard 20 Jun 2012, Col 866.
http://www.publications.parliament.uk/pa/cm201213/cmhansrd/cm120620/debtext/120620-0001.htm
[3] http://news.bis.gov.uk/content/Detail.aspx?ReleaseID=415487&NewsAreaID=2
[4] Lords Hansard 16 Aug 2010. http://www.publications.parliament.uk/pa/ld/ldtoday/writtens/16082010.htm#hdg-InstitutionalInvestorsVotingRecords
[5] Available at
http://www.fairpensions.org.uk/sites/default/files/uploaded_files/documents/StewardshipCodeFairPensions.pdf - see p7
[6] FairPensions, 2010, Stewardship in the Spotlight; PIRC, 2012, http://www.pirc.co.uk/news/voting-disclosure-revisited

5. The role of beneficiaries and retail investors

We welcome the fact that the revised Code gives greater prominence to beneficiaries as the people whom stewardship activity should ultimately serve. However, we believe that greater clarity and consistency in the language used here would be helpful.

For instance, the new introductory section 'Stewardship and the Code' refers to the *"ultimate providers of capital"* in paragraph 1. We take this to refer to individual savers. However, paragraph 6 refers to pension funds as *"the providers of capital"*, which could create confusion. The revisions to 'The Principles of the Code' refer to *"the ultimate beneficiary"*, while other sections of the Code refer to *"clients and beneficiaries."* We assume that the latter is intended to reflect the distinction between asset managers (who are immediately accountable to their 'clients') and asset owners (who are immediately accountable to their 'beneficiaries'). However, this is not entirely clear. Moreover, the term 'beneficiaries' could be read as excluding retail investors and pension savers enrolled into a contract-based pension product.

We appreciate that there is no single term which perfectly captures this complexity: the important thing is to be consistent and clearly define the scope of the terms used at the start. For instance, the Code could use the term 'beneficiaries' or 'clients and beneficiaries' throughout, clarifying at the start that this includes retail investors and contract-based pension savers.

On this point, paragraph 4 of the new section 'Comply or explain' refers to the FSA's disclosure requirement in relation to the Code, stating that it applies to *"all firms authorised to manage funds on behalf of others"*. Our understanding has been that the FSA requirement applies only to firms managing funds on behalf of institutional clients.[7] As we and others argued in response to the FSA's consultation, this is unfortunate since it implies that retail investors (including contract-based pension savers) are not considered to be an audience for stewardship disclosures. If stewardship duties are owed to the 'providers of capital', this seems difficult to justify. While institutional investors have been the predominant focus of the Code, this should not become a hard and fast assumption to the detriment of retail investors. It would be helpful for the Code to clarify that ordinary savers of all kinds are the ultimate beneficiaries of good stewardship, and that disclosures should be made with them in mind – both in terms of language and in terms of accessibility.

6. Assurance reports

We welcome the FRC's strengthening of the guidance on independent assurance. The IMA's most recent survey on adherence to the Code suggests that few signatories are obtaining such assurance; the proposed new wording should provide a valuable 'nudge' towards improving this situation, whilst retaining the flexibility for smaller signatories for whom assurance is not cost-effective to 'explain'.

We are somewhat confused by the deletion of the recommendation under Principle 3 that signatories should *"maintain a clear audit trail"* of their stewardship activities, since this seems to travel in the opposite direction from the amendment to Principle 7. We realise that this has been partially replaced by the new guidance under Principle 7 that signatories should *"have processes to maintain a clear record of their stewardship activities"*, but

[7] FSA Handbook Notice 104, p20

note that the new wording is somewhat less clear and specific. We would favour the reinstatement of the existing wording, transplanted into the guidance to Principle 7.

In our 2010 submission to the consultation on the original Code, we suggested that assurance reports should be made publicly available. We therefore welcome the confirmation that clients should be provided access to such reports on request. If some signatories are refusing to provide this, one must question the purpose of their having obtained assurance at all. Indeed, it remains our view that the purpose of assurance is to enable clients/beneficiaries/prospective clients to make more informed judgements about signatories' stewardship approaches, and that assurance reports should therefore be publicly disclosed.

7. Comply or explain

Our comments in this regard relate primarily to investors' role in the operation of 'comply or explain' at a company level, rather than to the 'comply or explain' mechanism of the Stewardship Code itself.

As the FRC is aware, our 2011 survey of asset managers identified the approach taken to company explanations as an area of weakness in stewardship disclosures. We found a tendency towards boiler-plate statements which gave no insight into how the managers judged whether an explanation was adequate. This contrasted with the best statements (Aviva is one example) which gave an insight into the specific issues that would be considered when judging a company's explanations. We welcome the FRC's efforts to bring greater clarity to the Corporate Governance Code regarding the features of a good explanation, and would suggest that a parallel amendment to the Stewardship Code regarding investors' own approach to judging explanations might help to ensure that these efforts are effective.

We note that the requirement for stewardship statements to include signatories' policy on considering explanations has been removed from the guidance to Principle 1, along with the other specific elements previously listed here. We note the consultation document's rationale that these are covered elsewhere in the Code. However, we were unable to find any reference to disclosing a policy on explanations elsewhere in the Code (as opposed to the recommendation under Principle 3 that investors should consider explanations). We would suggest that it is helpful for the key features of a good stewardship statement to remain in one place under Principle 1, particularly since not all of them are clearly replicated elsewhere.

8. Monitoring of adherence to the Code

We note that the FRC does not appear to be reviewing the status of the IMA survey as the primary vehicle for monitoring adherence to the Code. We had understood that this was always intended to be a transitional arrangement. We remain of the view that monitoring of adherence to the Code would be most appropriately conducted by the FRC itself, or outsourced to an independent academic body.

We would be pleased to discuss any of the issues raised in this response in more detail.
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