Revisions to the UK Stewardship Code

A response to the FRC consultation

Introduction

We are writing to comment on the above consultation document on behalf of the National Employment Savings Trust (NEST)[1]. We welcome the continuing development of the UK Stewardship Code and are pleased that the Financial Reporting Council (FRC) is proposing revisions that aim to strengthen the remit of the Code.

At NEST we are committed to encouraging the companies in which we invest to perform in the way we believe our members would like them to. To us, being a good steward means understanding how the companies we invest in on our members' behalf affect the societies and environments around them. Being a good steward also means encouraging these companies and the markets on which their securities are listed to operate appropriately day in, day out, year in, year out.

About us

From October 2012 onwards, employers in the UK will have a statutory duty to enrol some or all of their workers into a pension scheme that meets or exceeds certain legal standards. Employers will be required to make minimum contributions for these workers.

NEST is a defined contribution pension scheme that UK employers can use to meet their new legal duties. NEST is an easy to use, low-charge scheme that has a public service obligation to accept employers of any size or sector that want to use NEST.[2]

NEST Corporation is the Trustee body responsible for NEST. It is a non-departmental public body that operates at arm's length from government and is accountable to the UK Parliament through the Department for Work and Pensions (DWP).

The Trustee currently has a Chair and ten Trustee Members who have a fiduciary duty to act in the interests of the members of NEST when taking investment decisions.

NEST invests and owns stakes in thousands of companies globally and is likely to be among the very largest institutional asset owners in Europe in the future. How these companies are governed and run is a concern of the members of NEST. It will be a determinant of the performance of NEST's funds and members' incomes in retirement.

[1] We use the term NEST to refer to the scheme's legal name, the National Employment Savings Trust. We sometimes also use it to refer to the scheme's Trustee, the National Employment Savings Trust Corporation.

[2] More information about NEST is available at: http://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/key-facts-myths,PDF.pdf

Our response

In our response we provide comments on the appendix to the consultation document where we feel revisions can be further improved or expanded. Where we do not comment on proposed revisions, the FRC should assume we are either in agreement with these changes or have actively decided not to comment at this stage.

We have a profound interest in seeing the FRC develop a robust Stewardship Code that is fit for purpose. It should build on the good work of the Institutional Shareholders' Committee and earlier codes on corporate governance, while retaining the flexibility of the 'comply or explain' approach. Future success will be measured by institutional investors following the spirit of the Stewardship Code, via their voting and engaging activities and through enhanced disclosure on these activities.

The Stewardship Code is at an early stage in its development. For this reason, we believe it is important for the FRC to firm up the Code's remit and to feel comfortable that the principles are based on strong foundations and consensus. This belief means we have tried to focus our response on a few high-level areas, rather on individual word choice.

Points that we think merit further consideration are in bold.

Stewardship and the Code

Paragraphs 1-4
We agree that the Code would benefit from a definition and description of stewardship. Whilst the Draft Revised Code explains what 'stewardship' does and what it entails, it stops short of effectively delivering a clear definition.

To support this consideration, in the box below we pull together a small number of definitions and descriptions from a variety of sources. It is notable that while the context and situation differs in each case, the concept of stewardship is similar.

What is stewardship?

- In the middle ages, the term 'stewardship' was widely referred to when manors or estates were administered by stewards. These stwards who would report on their management in order to establish the reliability of their tenure to the often absent landlord (Mathews and Perera, 1996 page 12).
- Since the mid-19th century 'the concept of stewardship in accounting has referred to the separation of ownership and control which resulted from the use of the joint stock company structure. Thus, modern stewardship refers to the relationship between the managers and the owners (shareholders). The function of the ... [stewardship] statement then becomes that of demonstrating that the resources entrusted to management have been used in a proper manner' (Mathews and Perera, 1996 page 83).
- Online dictionaries suggest that stewardship comes from the Greek word 'oikonomia', meaning the management of a household or its affairs by another who is not the owner.
- Bryden and Hart (2000) define stewardship as care exercised on behalf of others by a person or body responsible for assets held individually or in common (page 4).

Based on the above, it seems to us that stewardship has in common the following:

1. the idea of a separation of management from final ownership
2. the idea of discharging a level of care
3. the idea of demonstrating that the resources entrusted by others have been used in a proper manner.

We believe that final owners, who in the vast majority of cases are members of the public, should be recognised as the real motivation for good and effective stewardship.

We would like to see the FRC bring together these attributes into an enduring definition and description of stewardship within the revised Code.

Paragraphs 5-6
We would like the FRC to review whether 'spectrum' is the right construct with which to imagine:

- the divisions of duties within and between institutions
- the variety of participants in the industry.

We are unclear as to whether having asset owners at one end of a spectrum and asset managers at the other is a concept that would resonate with parties across the investment chain. A more conventional investment chain where ownership is intermediated by connecting ultimate owners with their investment in companies may be appropriate here. This is described in the Myners Principles (2004) and might be considered a simple and well understood construct. **We believe there is merit in rethinking the idea of a spectrum.**

We believe it is important that organisations that have signed up to the Stewardship Code develop an awareness of where they are in the investment chain and the full set of accountabilities that belong to that position. **We would like to see the FRC ask signatories to disclose their role and position in the investment chain and the set of accountabilities that relate to this in the introduction to their statement.**

It should be for each signatory to disclose their role and position in the investment chain, rather than the FRC set definitions for asset owner, asset manager, and each other type of party.

This feels like an appropriate approach because we expect there will always be exceptions that disprove each definition. For example, NEST is an asset owner and is accountable to members who are the end investors. While we contract asset managers to create portfolios on our behalf, we decide the asset allocation in-house. It could therefore be argued that NEST also manages assets.

Similarly, the asset managers we contract know they are accountable to NEST and accept that they are also accountable to the end investors who are our members. They might therefore reasonably view themselves as both asset owners and asset managers.

It may be expected that definitions become even more blurred once the Stewardship Code realises its ambition of moving beyond UK jurisdiction.

Paragraph 6
We agree that asset owners are responsible for setting the tone for stewardship and may influence behavioural changes that lead to better stewardship by asset managers. **We would like to see the FRC provide more guidance on how this might be achieved.**

We feel that by providing greater guidance in this area the Code can be used to encourage asset owners to challenge, monitor and understand the actions of their fund managers to whom they delegate the responsibility of managing investments for the end investor.

Application of the Code

Paragraph 1
We believe the origins of the term ‘stewardship’ and the Stewardship Code would benefit from being more clearly defined. We believe part of this clarification could be achieved by the Stewardship Code more fully referencing its roots within the Cadbury Report (1992) and the successor reports on corporate governance.

The 2009 Walker Report recommended that Section E of the Code be withdrawn from the Combined Code on Corporate Governance and replaced with a ‘Stewardship Code’ for institutional investors (page 17).

We would like to see the FRC reword the origins of the Stewardship Code to include important elements of the antecedents to the Cadbury Report. We believe this will help improve others’ understanding of the term ‘stewardship’ and its link to voting and engagement.

Paragraphs 4 and 8
To us, stewardship means serving end investors by exercising care over the assets they entrust to us. It also means providing them with assurance through reporting on the activity we carry out in this area.

Since stewardship first and foremost concerns the end investor, we believe members of the public should be able to readily find and access the Stewardship Code statement on the website of the organisation they are investing with.

Based on this belief, **we would like to see the Code recommend that signatories publish their Stewardship Code statement and compliance statement, if they need to produce one, on an easily accessible area of their website.**

The expectation is that this will usually be each firm’s public-facing website, presumably a UK version to match the largely UK remit of the Code. **We also believe that the Code should encourage signatories to write statements and report in a language accessible to interested members of the public with limited knowledge of institutional investment.**

Paragraphs 7 and 9
We believe there is merit in the FRC removing both these paragraphs or migrating them to the main body of the Code. Both paragraphs are more concerned with guidance on principles than general matters on the application of the Code.

It is worth noting here that we support the introduction of independent verification for asset managers. However it should be recognised that smaller asset managers may not have the resource to meet this requirement effectively. **The FRC may wish to consider consulting with The Institute of Chartered Accountants on whether it would be appropriate to apply an AUM threshold to the requirement to gain independent assurance.**

In principle we see no reason why asset owners should not be expected to seek their own independent verification of their Stewardship Code statements. It will further encourage them to hold their appointed managers to account on the implementation of stewardship on their behalf. That said we would not wish the introduction of mandatory independent verification to make smaller asset owners reluctant to sign up to the Code. **This may be an area that the FRC wish to consult on next time.**

Paragraph 10
We are pleased the FRC has put the application of the Code in other jurisdictions on the agenda. For the purpose of clarity, **we would like to see an additional sentence developed recognising that not all the principles may be natural and appropriate for other jurisdictions.**

This would include an acknowledgement of the possibility of greater value in forms of stewardship not mentioned in the Code according to the situation, circumstance and jurisdiction. This could include class actions and the many forms of binding and non-binding enforcement found outside the UK.

Paragraph 11
We welcome disclosure on whether institutional investors apply the principles to other asset classes, including corporate debt. However we would like the FRC to go further and encourage institutional investors to apply the principles on a best-efforts basis to other asset classes in the same light as overseas equities. **We would be happy to see the FRC ask signatories to explain if there are types of equities that stewardship is not applied to, for example certain industries or markets.**

Comply or explain

We would welcome greater guidance from the FRC concerning the reporting of compliance with the Code. It is not immediately clear whether the Stewardship Code statement and the compliance statement are expected to be a single combined document or separate documents.

We think it would be helpful if the FRC was to provide examples of what it believes constitute appropriate comply or explain narratives.

The Principles

Principle 1
Within the guidance there is significantly more content on engagement than voting. This may give the impression, rightly or wrongly, that the FRC sees engagement as more important.

We believe it would be appropriate for the FRC to take an approach that gives more even weight to voting and engagement. This might involve adding a sentence on the importance of voting in a purposeful and thoughtful manner.

We suggest removing the third paragraph of the guidance 'the disclosure should be posted on the institutional investor's website, or if it does not have a website in another accessible form.' This is already stated on pages 3 and 4 of the Draft Revised Code.

There may also be merit in the FRC asking signatories to describe the stewardship activities they carry out on behalf of those to whom they are accountable.

Principles 1 and 3
Principle 1 and Principle 3 concern engagement only with companies. We see engagement as far more than this. Engagement to us is a mixed-use term that encompasses the opportunity to communicate in order to learn more, to develop key relations, seek to influence and help create change where it would benefit our members.

This may be performed by engaging with standard-setters, regulators, key stakeholders, market providers and fund managers, as well as companies.

Influencing the operation of a single framework stands to be more effective at a portfolio level than influencing the behaviour or attributes of a single company. **We would welcome the FRC recognising the range of engagement that may have merit for signatories.**

We believe there is also merit in suggesting an all-encompassing definition of engagement within the FRC's explanation of the term stewardship in the preamble to the Draft Revised Code.

Principle 6
Within the guidance we would like to see emphasis on the importance of voting purposefully and thoughtfully on all shares held outside of the UK where it is practical to do so.

While we recognise the UK remit of the Code, UK equities only make up around 40 per cent of institutional investors' equity portfolios (see *A long-term focus for Corporate Britain*, IMA, 13 January 2011). This means that most of the economic impact is derived from overseas equities. **We would like the FRC to encourage UK investors to vote on those shares that carry the most weight economically in an informed and purposeful way.**

Bibliography

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