NAPF
Securing the future of pensions

FRC Consultation on a Stewardship Code

NAPF Response April 2010

Introduction

The NAPF has been a supporter of higher standards of corporate governance for many years. It recognises the importance of the role played by shareholders in maintaining good standards and acknowledged that role in its review of the Myners Principles which was published in 2007. Our surveys of larger pension schemes indicate that a significant majority take these responsibilities seriously: they have developed policies and they monitor how the policies are applied by their managers.

As a member of the ISC, the NAPF was an author of the original Principles as well as the new Stewardship Code which is based on them and is committed to supporting them.

The challenge for the FRC and for the investment industry is to translate the Code's Principles into a regime which provides better support for the Combined Code without imposing an inappropriate regulatory burden on investors.

We see the Stewardship Code as an early step in the development of more constructive relationships between companies and shareholders. It is vital that at this stage it is structured in such a way as to garner support from a wide cross section of investors and issuers. There is a real danger of its application developing into a compliance exercise, with no real benefits for end investors.

ISSUES FOR COMMENT

Section 1: Introduction

- The FRC would welcome views on the policy objectives against which the FRC should judge its approach to a Stewardship Code.

  NAPF response: The NAPF welcomes the involvement of the FRC in overseeing the Stewardship Code. As most pension funds delegate the responsibility for engagement to third parties, they will benefit from standards being set independently of the asset managers, as that will provide an objective assessment of those standards and over time will encourage greater consistency in their application. However, the policy objectives set out in the Consultation Document are in our view too detailed. The FRC should concentrate on fewer high level objectives which will encourage the industry to adopt the Code. We suggest that the objectives should be:

1. *to encourage widespread adoption of the Code by institutional investors;*
2. *to improve the effectiveness of the dialogue between issuers and investors (including the incorporation of engagement into the broader investment process) ; and*
3. *to encourage the development of better standards of monitoring and reporting by investors to their end-clients.*

   Each of these can be assessed periodically, partly, but not exclusively, through the established surveys conducted by the NAPF and the IMA.

   The FRC should be prepared to accept, certainly in the early days, wide variations in the way in which the Code is applied/adopted. For example smaller pension funds will inevitably approach it differently from larger ones and the pensions industry will need to consider how to address this challenge. However over time we would expect to see accepted standards of best practice evolve and would encourage the FRC through its monitoring of the Code to foster the adoption of higher standards by the industry. As part of that evolution we believe that the Code should increasingly differentiate between the responsibilities of end-investors such as pension funds as compared to their agents, including consultants and proxy advisory firms.

   The NAPF published its initial thoughts on the Code (ISC Code – First Steps) in February which appears to have been well received by pension funds. A copy is attached to this response.

   We anticipate that some reviewing/oversight body will be established in due course. It is important that it contains representatives from among the occupational pension schemes to ensure that the voice of the end-client is heard.

- The FRC is seeking views on whether it should accept oversight of the Code in its current form, or whether amendments should be made before the FRC does so.

  NAPF response: as a member of the ISC and therefore a co-author of the ISC Code, the NAPF believes that it represents a good start to the process of improving institutional investors' approach to stewardship issues. No substantive changes are needed at this point. If the bar is set too high there is a risk that adoption of the Code will be slower than is desirable.

  If investors can apply its principles to a reasonable standard it will be for the benefit of pension funds and their members. As a result of its application we expect the principles over time to evolve in much the same way as the Corporate Governance Code has since the publication of the Cadbury Report. It is therefore important that market participants encourage critical review and debate over its workings. The NAPF will continue through its surveys and member contacts seek to understand how best practice is developing.

- Views are also sought on which institutional investors and agents should be encouraged to apply the code on a "comply or explain" basis, what they should be asked to disclose and to whom, and the monitoring arrangements that should be put in place (paragraph 1.17).

NAPF response: We believe that the Code should be applied, as appropriate, by all in the investment chain, including proxy agents and investment consultants. It is for those responsible for the day-to-day management of investment portfolios to determine their approach, depending on their investment process and philosophy. This presents pension funds and their advisers with the challenge of assessing different managers and will necessitate changes to the conventional model for reviewing current and prospective managers. We believe this would be a healthy development.

There is a real danger that disclosure becomes a compliance exercise with too much focus on voting activity and too little on effective engagement. We have consistently advocated that voting reports should be prepared on an exceptions basis, with a focus on policy overrides, votes against management and conflicts of interest. These lead directly to a discussion of engagement activity. We believe that over time a shift in the focus of manager reviews towards stewardship issues would be healthy. This depends on the construction of an appropriate infrastructure by their asset managers, their consultants and the pensions managers themselves. While there is a perceived challenge for smaller funds who make use of pooled funds and who may feel they have little influence on engagement policy, we believe that size alone should not deter funds from interrogating their managers on the application of the Code.

There is perhaps a greater problem for the smaller investment manager with limited resources who will not normally hold large positions in individual companies and may therefore have difficulty in engaging with management. However the Code will encourage institutional investors to articulate more clearly their approach to stewardship and the extent to which their investment process in reality relies on direct contact with managements.

We believe that stewardship monitoring should form an integral part of a manager review. Investment managers should be prepared to discuss any contentious issues which may have arisen during a reporting period (eg their actions during the bid for Cadbury).

Pension funds have to date seen very little demand for reporting from their individual members. However as reporting standards are rising so it is appropriate that funds expand their commentary on stewardship. We are impressed with the approach taken so far by NEST and see it as a standard for other providers and scheme sponsors.

The NAPF in its 2007 review of the Myners Principles reiterated the relevance of the then ISC principles to pension fund investment and recommended that they be incorporated into the IMA or SIP as a matter of best practice. Since then the Investor Governance Group has taken responsibility for overseeing the application of the Myners Principles.

Section 2: Background and Recent Developments

- The FRC would welcome any insights on lessons which may be learned from experience outside the UK (paragraph 2.18).

  NAPF response: Nothing to add

Section 3: The Coverage of the Code

- The FRC would encourage all UK institutional investors to apply and report on the Code regardless of whether or not they are subject to mandatory requirements, and would welcome views on whether there are any barriers or other reasons that would prevent or discourage them from doing so (paragraph 3.6).

  NAPF response: See above. In addition we note concerns among local authority pension schemes who are subject to the Freedom of Information Act that they may be required to publish data which is of limited relevance to an assessment of the effectiveness of application of the Code, but may be possibly damaging to effective engagement as well as being time consuming to produce . Asset management firms are also concerned about confidentiality and the FRC should consider how best to reconcile these concerns with an understandable desire for transparency and accountability.

  We also support the suggestion from Hermes" that certain pooled funds do not allow different voting instructions for different end clients. This means that the asset owners whose assets are held within such vehicles are unable to vote all their shares in accordance with their wishes. We believe that it should be a requirement of such pooled funds to enable voting decisions to be made by the underlying asset owners and reflected in the votes cast". We would also encourage funds to disclose their policies on recalling stock for voting purposes where they operate a stock lending programme. These considerations are of growing importance given the expansion in defined contribution pension schemes.

- Views are invited on whether agents such as voting services agencies and investment consultants should be encouraged to commit to the spirit of the Code, and if so how this could be done (paragraph 3.8).

  NAPF response: as noted earlier we believe that voting agents and investment consultants should commit to the Code. Their role is integral to effective stewardship. The first offers research and/or voting services. The second sets the agenda for many trustee meetings and advises on manager selection. If the consultant will not incorporate stewardship concepts into his responsibilities, there is a real danger that there will be limited take-up of the Code by pension funds.

  This can be done by encouraging more transparency among the proxy agencies on matters such as policy formation and a retrospective analysis of policy application. We note that there is evidence that investment consultants are improving their coverage of stewardship matters, partly in response to client demand. We believe *that the NAPF can play a useful role in promulgating best practice ideas and began that process with the publication of our Guide to the Code in February.*

- The FRC is keen to hear from foreign investors in response to this consultation, and would in particular welcome comments on:
    - Whether foreign investors would be willing voluntarily to commit to a Code sponsored by a UK regulator such as the FRC or a UK industry body like the ISC in respect of their holdings in UK companies;
    - Their current practice on disclosing information on their engagement policy, including any national or international standards they follow; and
    - Any barriers or other potential difficulties for foreign shareholders seeking to engage with UK companies (paragraph 3.13).

  NAPF response: N/A

- The FRC would also be interested to hear from investors who operate on a cross-border basis about any potential conflicts which might arise between requirements or codes in place in other countries and the proposed Stewardship Code (paragraph 3.14).

  NAPF response: we are concerned about dual standards, as pension funds continue to reduce their exposure to UK equities. It is in their interests to pursue higher standards of corporate governance for all their investments and it is quite possible that from time to time problems at a foreign company may take precedence over a UK one. We note that other countries are considering the introduction of a Code for investors, which may present challenges in terms of compliance if standards differ markedly. We like the suggestion from Standard Life that the FRC should actively support cross-border collaboration, through the establishment of a "Global Stewardship Committee".

  Several of our members also support the Swedish model of director nomination and we agree that it is worth consideration, despite some obvious practical difficulties in its implementation.

Section 4: The Content of the Code

- Respondents are welcome to comment on any aspect of the ISC Code, but in particular views are invited on these questions:

    - What are the responsibilities for engagement of institutional investors to the beneficial owners whose interests they represent? Does the ISC Code cover all the relevant responsibilities?

      NAPF: for pension funds these will depend on the mandate which is agreed between the trustees and their investment managers. Members of occupational pension funds (both DB and DC) are not the beneficial owners. However it is reasonable to expect funds to report on how the trustees have overseen any engagement responsibilities which they have delegated to their investment managers.

- What are the responsibilities for engagement of institutional shareholders to the UK listed companies in which they invest? Does the ISC Code cover all the relevant responsibilities?

  NAPF: The Code should not be prescriptive here. Engagement comes in different forms, from considered voting through to activist. Each can be seen as a legitimate means of protecting clients' interests.

- Are the respective responsibilities of the different parts of the investment chain sufficiently clear and appropriate?

  NAPF: The Code would benefit from greater differentiation between the responsibilities of pension funds and other "owners" as against those of the investment managers and the advisory firms. There is considerable overlap inevitably and some funds for example would be classed as both owners and investment managers. It would assist the majority of the pensions industry if the different responsibilities were defined better.

- Does the Code strike the right balance between the need to avoid overspecification that might discourage the application of the Code and the need for it to be effective with an appropriate degree of transparency?

  NAPF: Our judgement is that it does at this point, but that balance will change as the Code is put into practice.

- Are there any parts of the ISC Code where further guidance is needed, or where the existing guidance should be amended? (paragraph 4.2)

  NAPF: There is wide support from among our members for more and better collaboration between investors. The NAPF is directly addressing this demand through the launch of its "Corporate Governance Pensions Connections" service, which aims to provide both information on corporate governance and a route for pension funds to work together on stewardship. We are also directly involved in the work being done under the aegis of the ISC to improve collaboration between investors. The FRC should monitor such initiatives to assess whether they are proving to be effective.

- Views are invited on whether the ISC Code adequately covers the content of Section E of the Combined Code (paragraph 4.4)

  NAPF response: No comment

Section 5: Reporting, Monitoring and Review

- The FRC would welcome views on:
  - The information that institutional shareholders should disclose publicly and that they should report to clients;
  - The arrangements that should be put in place to monitor how institutional shareholders apply and report against the Code; and
  - The arrangements for reviewing the operation and content of the Code (paragraph 5.2).

- The FRC would welcome views on the specific information that should be disclosed by institutional shareholders and their agents, and at what level of detail the "comply or explain" principle should apply (paragraph 5.3).

- Views are invited on whether public disclosure of the information summarised is appropriate and useful, and whether other information might also usefully be disclosed (paragraph 5.6).

NAPF response: This has caused most discussion and debate among members and it is fair to say that there is as yet no consensus on monitoring. We believe it is important that some basic standards are set and welcome further discussion as the FRC collects views from the industry. As a start we make the following suggestions:

All institutional investors who claim to comply with the Code should be required to state, publicly and at a policy level, what is meant by compliance. Asset managers should publish on their websites an annual review of the application of that policy, which will include summary engagement and voting reports, consisting of policy exceptions and commentary on issues of particular interest. Pension funds, many of whom employ several managers, should be able to rely on that information to satisfy their requirements under the Code, in order to avoid duplication of work. Many of course do not have websites so reference should be made to the link in the annual report or similar publication.

We believe that the approach to application and reporting is a matter for industry practitioners and believe that the risk of box-ticking would be very real if this function were to be taken on by a regulatory body. A strengthening of the requirements under AAF 01/06 is well worth considering as that will address some of the operational issues. Otherwise it is for the end-clients to assess with the help of their advisers the standards of stewardship achieved by their investment managers. We expect that the FRC will monitor reporting standards and, as suggested elsewhere, seek to raise these over time. The NAPF will be working with its members on reporting standards and intends to issue guidance in due course.

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