

16 April 2010

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Financial Reporting Council
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Dear Susannah

Consultation on a Stewardship Code for Institutional Investors

CIPFA is pleased to offer its comments on the above consultation document.

We are the leading professional accountancy body for the public services. CIPFA is responsible for the education and training of professional accountants and for their regulation through the setting and monitoring of professional standards. CIPFA is also the leading independent commentator on managing and accounting for public money. CIPFA members are well-represented across the accounting community in the public sector and the wider CIPFA group is active in supporting financial management improvement in government.

Areas of active interest for the Institute are the financial management and governance issues surrounding the Local Government Pension Scheme (LGPS). These interests are pursued through a panel of our members (supplemented by specialists) drawn from senior positions across the Local Government Pension Scheme, including fund actuaries, auditors and regulators. The LGPS holds combined assets of over £110 billion (as at 31 March 2009) across 100 individually managed funds across the UK. CIPFA, via its Pensions Panel and recently formed Pensions Network, provides guidance and support to LGPS practitioners in the field.

Overall conclusions

This response has been prepared by CIPFA officers and has been reviewed by our Pensions Panel. We are pleased to offer the following observations on the FRC proposals, which are largely from the perspective of pension funds in the public sector.

CIPFA has recently published guidance to assist LGPS funds implement the recently revised Myners principles for institutional investment decision-making, in which the Institutional Shareholders Committee Code of Practice is cited as a source of guidance on investor engagement. As such the Institute has a keen interest in any developments in the ISC code and we are generally supportive of this FRC initiative to promote shareholder engagement.

However we have some concerns as to how this Code is intended to work alongside other principles and codes of practice concerning responsible investment and shareholder engagement such as the Myners principles, UN Principles for Responsible Investment (UNPRI) etc, and the additional resources that may be required to comply



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with yet another code of practice, particularly in the public sector where cost are under intense scrutiny and levels of compliance with existing guidance are already very high.

We have also set out below some observations on how changes to the structure of the Code might help to encourage participation and produce more focused outcomes.

Section 1- Introduction

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

- Set standards of stewardship to which mainstream institutional investors should aspire, and maintain the credibility and quality of these standards through independent input on the content and monitoring of the Code;***
- Promote a sense of ownership of the Code amongst institutional investors in order to encourage UK and foreign shareholders to apply and report against it;***
- Ensure that engagement is closely linked to the investment process within the investment firm;***
- Contribute towards improved communication between shareholders and the boards of the companies in which they invest; and***
- Secure sufficient disclosure to enable institutional shareholders' prospective clients to assess how those managers are acting in relation to the Code so that this can be taken into account when awarding and monitoring fund management mandates.***

Overall these objectives seem sound and in-keeping with the intentions set out in the recommendations of Sir David Walker's 2009 governance review. However we consider that there would be merit in setting these objectives in the wider context of the intended FRC strategic outcome, with particular reference to how the objectives apply in a public interest setting. This would help to bridge the gap between the FRC's wider purpose and the current ISC code of practice which is firmly founded upon the duty of institutional investors to end beneficiaries and not to the wider public.

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.

There are a number of amendments that could be usefully made to the code prior to its adoption by the FRC. These are summarised below and expanded on later:

- Adaptions or variations of the Code to reflect the different roles and responsibilities of specific groups of organisations in the investment chain***
- Further consideration of the level and type of public reporting required by the different groups in the investment chain***

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.

In the ISC code, the term “institutional investors” is given to encompass a number of parties along the investment chain from pension funds through their advisors to asset managers, and each are treated equally under the code.

Under a voluntary compliance arrangement, this in itself is not a particular drawback, as organisations can choose those elements that apply and adapt to their own circumstances if they, and their immediate stakeholders, wish.

However when elevated to a “comply or explain” regime, with a responsibility to explain and justify their decisions publicly, a rigid Code that does not take account of the specific roles and responsibilities of the different organisations that make up the investment chain may present difficulties for some organisations.

The investment chain can be subdivided into three distinct groups: pension funds/insurance companies (asset owners); investment, governance and voting advisors (owner agents) and fund managers (asset managers). As each has a role to play in the engagement process, the Code should cover all sectors. However as each sector’s role is different, serves different stakeholder interests and has varying public reporting requirements and practices, there are grounds for approaching the Code from these three different perspectives. This could be achieved under a common set of overriding principles as currently set out in the Code, but with the guidance adapted and strengthened for each particular sector. Alternatively the Code could be modified to recognize the inherent differences amongst the investor community and allow them to modify and apply the Code themselves to suit their own particular place in the investment chain.

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.

From a pension fund perspective there are undoubtedly costs associated with applying codes of practice such as the ISC code, Myners principles, UN Principles of Responsible Investment etc. The necessary policy formulation, monitoring, engagement activity and reporting are resource-intensive, whether they are undertaken in-house by pension funds or out-sourced to advisors. There is also the danger that those further along the investment chain (asset managers, custodians etc) will pass on the cost of compliance to their clients, thereby imposing yet further costs upon pension funds. Consequently funds may find these costs prohibitive and be dissuaded from engaging with the Code.

In a public sector context these costs would ultimately fall upon the public sector employers partaking in schemes, such as the LGPS, at a time when public sector budgets are already under pressure.

A further consideration is that the many different constituencies which make up the “institutional investor” community have varying degrees of public reporting requirements. In the public sector this is not a major concern, where the levels of transparency are high and annual reports are required to be published. However there is no requirement and no history of routine information being made publically available by private sector pension funds. The absence of an existing vehicle through which to report as required by the Code might also act as barrier to compliance.

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.

As noted above we would agree that it is important that all parties in the investment/engagement chain be encouraged to apply to the code of practice in so far as its requirements are pertinent to the role they play. To encourage participation, we suggest that the Code of Practice should either be modified for each particular group within the “institutional investor” community. This could be achieved under a common set of over-riding principles as currently set out in the Code, but with the guidance adapted and strengthened for each particular sector. Alternatively the Code could be modified to recognize the inherent differences amongst the investor community and allow them to modify and apply the Code themselves to suit their own particular place in the investment chain.

Section 4: The Content of the Code

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?

The primary responsibility of pension fund managers to their beneficial owners is to ensure that the fund has sufficient assets to meet pay the pensions promised under the pension scheme. Where investor engagement contributes to achieving this objective, we would agree that the fund manager has a responsibility to engage in order to protect the financial interests of the fund. That said, we would expect managers to be able to demonstrate that the costs of doing so do not outweigh the likely benefits.

If positive non-financial outcomes can be achieved from engagement that does not financially disadvantage the fund, and those aims accord with the wishes of the end beneficiaries, then managers should consider introducing a policy of engagement appropriate to their fund. However it is perhaps overstating the case to classify this as a primary responsibility.

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

As noted earlier, we feel that this is an area of the Code that requires further consideration, perhaps by producing variations of the Code for each particular group of bodies within the investment chain (see above).

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?

We believe that the principles of the Code are capable of being implemented as written subject to:

- the provision of suitable and targeted supporting guidance;
- guidance that sets the Code and the principles in the wider context of pension fund governance, such as the relationship with the Myners principles, UNPRI etc.

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

Please see the earlier comments.

Views are invited on whether the ISC Code adequately covers the content of Section E of the Combined Code.

There is a high degree of convergence between the requirements of the ISC code and Section E of the Combined Code. However it would be helpful if the link between the two were strengthened by specific cross-references.

Section 5: Reporting, Monitoring and Review

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.

The disclosures set out in the consultation document should be adequate to demonstrate compliance with the principles of the Code, and it is at this level that participants should be invited to “comply or explain”. Widening the range of compliance to include the guidance that sits behind the principles runs the risk of overspecifying the requirement, which may in turn discourage participation and compliance.

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

If, as is suggested in the consultation paper, the Code is intended to operate as a public interest tool then a high level of public disclosure will be required in order to meet the stated aim of promoting “better understanding and communication between companies and investors and to assist the investment chain to operate more effectively”. The level of disclosure suggested in the ISC code would meet these requirements.

As mentioned earlier, in the public sector there are high levels of transparency and statements of investment policy and annual reports are required to be published.

However there is no requirement and no history of routine information being made publically available by private sector pension funds. The absence of an existing vehicle through which to report as required by the Code may act as a barrier to compliance.

Views are invited on the proposals in ISC Code for reporting to clients and the merits of independent opinions from auditors or other professional accountants. It would be helpful to have estimates of the costs incurred by asset managers in commissioning these opinions and of the benefits to asset owners.

Pension funds will often rely upon their asset managers to undertake voting on their behalf. Therefore we believe that it would be a useful source of assurance for pension funds if the engagement and voting processes of their asset managers were subject to independent review. This could be achieved by extending the scope of the AAF01/06 assurance report.

Views are invited on the merits of the current IMA survey and other possible approaches to monitoring the overall application of the Code.

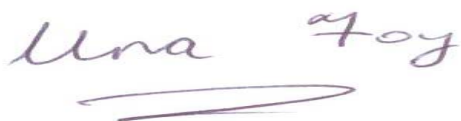
Recognising the limitations of the IMA survey, there are a range of other industry bodies that may be willing to undertake the necessary monitoring surveys of their members organizations (NAPF, ABI, SPC etc). These organizations already survey their members on a wide range of issues on a regular basis and CIPFA would certainly consider undertaking such surveys for the Local Government Pension Scheme. This would avoid the need for an entirely new layer of monitoring arrangements.

Views are invited on the proposed approach to reviewing the Code.

We agree with the overall approach to review as set out in the consultation document. This is similar to the approach undertaken on the Myners principles which has worked well in the past.

I hope that you find these comments a useful contribution to the development of the ISC code. If you have any questions regarding any of the above comments, please contact the secretary to the CIPFA Pensions Panel, Nigel Keogh, at nigel.keogh@cipfa.org.

Yours sincerely

A handwritten signature in purple ink that reads "Una Foy". The signature is written in a cursive style and is positioned above a horizontal line.

Una Foy
Assistant Director, Professional Standards and Central Government

