

2020 Stewardship

Improving the quality of
investor stewardship

A report of the Investor Stewardship Working Party



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Foreword

by the Investor Stewardship Working Party

The Investor Stewardship Working Party is a group of six institutional investors, supported by Tomorrow's Company.

We are all committed to shareowner stewardship and have come together because we share concerns about the quality of stewardship in equity markets. This underpins the fiduciary duty which we owe to our clients and beneficiaries.

Our purpose is to influence the debate on the development of stewardship and to recommend and help implement solutions; to ensure that the UK Stewardship Code becomes embedded in practice and does not just become a box-tickers' charter.

This report provides a framework to help achieve better investor stewardship, in partnership with companies, and contains recommendations for action. Our immediate purpose is not to resolve all the major problems of today such as executive remuneration but to help create a better framework which will over time make such issues easier to resolve.

There is more to be done to pursue each of the four recommendations, and more to be done beyond them. We would like to invite other investors, companies and representative organisations, who share our belief in the importance of better investor stewardship, to contact members of the working party so that we can work together on this agenda.



Anita Skipper, Aviva Investors



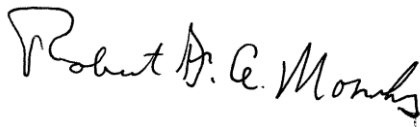
Amra Balic, BlackRock



Peter Butler, Governance for Owners



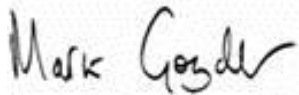
Frank Curtiss, Railpen Investments



Bob Monks, Ram Trust



Daniel Summerfield, USS



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Executive summary

The UK has the world's first code for investor stewardship. Improving the quality and quantity of investor stewardship will help make the code a working reality. 20/20 vision is needed to clarify what is meant by investor stewardship and to find ways to help investors and companies put this into practice building on many years of progress in UK corporate governance. Introducing value-adding stewardship programmes takes time but we anticipate full and effective implementation will have been achieved by 2020. Our ideas are aimed at the UK but we believe that they will be of value in other markets.

We believe that a critical mass of investor stewards is vital. We also recognise that not every shareholder can or needs to be a good steward. There is nothing wrong in NOT signing up to the Stewardship Code when an institutional investor has products that are not suitable, or is too small, or is a non-believer in the benefits of stewardship. The findings in this report represent both our own experience and what we have learnt from our dialogues with companies and representative organisations.

The challenges which we have identified are about both the **quality** and the **quantity** of stewardship:

- quality of meetings – companies want meetings and engagement that are more purposeful and effective and give a deeper account of the company – more access to investors, more in-depth discussion, fewer meetings that are 'a waste of time', better joint handling of issues that reach the media, better feedback. They are frustrated by investors who present a divided face on company performance and governance issues
- quality of information – there is a lack of information about the stewardship approaches of different asset managers and a lack of comparability to help asset owners make informed decisions
- resource limitations – the resources for stewardship are limited and we are not making best use of those which we have. Index investors are a vital part of the market and often have the desire and the capability to be stewards, but companies sometimes dismiss them as unimportant
- critical mass – for the sake of beneficiaries and companies we need to build a critical mass of stewardship investors – funds which are capable of engaging companies in constructive dialogue and holding their boards accountable to shareowners.

The working party believes that these challenges can be addressed by:

- creating a simple **guide to good engagement practice**, in particular to encourage more productive meetings, jointly developed by companies and institutional investors
- companies and institutional investors finding more ways to **seek feedback on the quality of meetings** and over time use this to identify and improve good stewardship. Encouraging institutional investors who are signatories of the UK Stewardship Code to be more transparent about the extent to which they intend to exercise stewardship as part of a product offering
- **a 'Stewardship Framework' against which institutional investors can categorise themselves** which we have developed as a starting point for discussion (*see overleaf*). Over time, these public statements can be substantiated and ultimately reinforced by the evolution of the AAF 01/06 guidance on internal controls and stewardship. Public statements based on this framework will not only help asset owners compare the stewardship activities of different fund managers and so make more informed decisions. It will also assist companies to identify the stewardship investors on their share register
- companies helping to increase the critical mass of stewardship by **developing a 'Stewardship Profile' of the current extent of stewardship investors on the register and a 'Plan' to achieve an appropriate level**. Each company would report on progress towards this and further develop its investor relations function in areas of 'stewardship relations'. Such plans would need to recognise the important role of passive investors.

We have identified certain areas for further study, for example: collaboration, director nominations, the free rider problem and remuneration.

To help follow through the recommendations, the working party is inviting other interested bodies to take action. In particular:

- the FRC to incorporate our ideas into their programme to improve the effectiveness of the Stewardship Code
- bodies which represent asset owners and asset managers to promote stewardship categorisation within an agreed overall framework
- to work together in the future with others who agree with our recommendations.

Stewardship Framework on Equities for Asset Managers

Description

It is envisaged that asset managers that have signed up to the Stewardship Code will be required under Principle 1 to disclose their approach to stewardship within a generally agreed matrix framework, as per criteria below. Explanations (with supporting evidence) must be provided on the asset manager's website. In time, it is anticipated that a public statement on activities will be audited under AAF 01/06. Over time, clients may require this by products or by groupings of similar products.

Category	Full Range of Stewardship Activities / (Approach A)	Some Stewardship Activities / (Approach B)	Limited Stewardship Activities / (Approach C)	Exemptions/Further Explanation
Voting	Votes at least 90% of portfolio holdings	Votes less than 90% but greater than 60% of portfolio holdings	Votes less than 60% of portfolio holdings	Does not vote portfolio holdings due to investment approach (e.g., short-term fund), firm size (less than £1bn AUM firm-wide), type of securities (e.g., synthetic ETFs, non-voting shares) or client instructions (for segregated mandates)
Engagement	Engages proactively on a full-spectrum of topics (ESG, strategy, performance, financials)	Engages principally on a reactive basis and on a limited range of topics	Does not engage or rarely engages with investee companies on ESG matters	Does not engage with investee companies due to investment approach (e.g., short-term funds), firm size (less than £1bn AUM firm-wide) or client instructions (for segregated mandates).
Policy activities	Actively contributes to key policy debates on stewardship in all relevant geographies	Contributes to selected policy debates on stewardship in some geographic regions	Rarely or does not contribute to policy debates on stewardship	Does not contribute to policy debates on stewardship due to investment approach (e.g., short-term fund) or firm size (less than £1bn AUM firm-wide)
Integration	Full integration between the investment and CG/ESG teams on voting, engagement and policy activities. Integration into index funds/products in accordance with the investment strategy.	Some collaboration between the investment and CG/ESG teams on voting, engagement and policy activities	Rare or no collaboration between the investment and CG/ESG teams on voting, engagement and policy activities	Investment and CG/ESG teams not integrated due to investment approach (e.g., quant funds or index funds)
Reporting to clients	Detailed written reports on stewardship activities to clients and in-person meetings (or equivalent) with clients to discuss stewardship activities at least annually	Detailed written reports on stewardship activities to clients	Summary reporting of stewardship activities	
Compensation/ incentives for investment staff	Compensation for investment staff based on at least 3-year portfolio or firm performance	Compensation for investment staff based on at least 2-year portfolio or firm performance	Compensation for investment staff based on less than 2-year portfolio or firm performance	
Conflicts of interest	There are no, or immaterial, conflicts of interest, or conflicts are fully mitigated.	There is an active effort to avoid and mitigate conflicts of interest	There are unresolved/unresolvable material conflicts of interest	
Public transparency*	Comprehensive and detailed disclosure on website of stewardship policy, approaches and activities and other relevant matters to investee companies, clients and the public	Moderately extensive disclosure on website of stewardship policy, approaches and activities to investee companies, clients and the public	Summary disclosure on website of stewardship policy, approaches and activities to investee companies, clients and the public	
<u>Qualification thresholds</u>	<i>A manager qualifies under this category if at least 6 out of 8 of the above criteria are rated as Full Range of Stewardship Activities (one of which must be Engagement) and there is no Limited Stewardship Activities rating.</i>	<i>A manager qualifies under this category if at least 6 out of 8 of the above criteria are rated as Full Range or Some Stewardship Activities (one of which must be Engagement).</i>	<i>A manager qualifies under this category if it does not qualify under any other category.</i>	<i>A manager qualifies under this category if it meets at least 3 out of 4 of the above criteria. Otherwise, it will be classified as either Full, Some or Limited. A firm falling under this category can elect to self-categorise (in which case it must meet the same standards as a non-exempt firm or product).</i>

* Extensive and full discussion of the quantum and quality of stewardship, including the following (non-exhaustive): Policy on engaging investee companies (e.g. holding thresholds, types of issues, key contacts); resources allocated to stewardship activities; engagement approaches (including escalation policy and methods/frequency of collaboration); meetings held with investee companies and other interested parties; successful and unsuccessful engagements; integration of stewardship activities in portfolio management; avoidance, mitigation and management of conflicts of interest; compensation structure of investment staff and other relevant personnel; key internal decision-making processes and organs on stewardship matters; etc. Asset managers should strive for a level of clarity that would enable 1) investee companies to understand (ex-ante) when, on which topics, and with whom they can engage on stewardship matters and 2) clients to distinguish different equity products on the key dimensions of stewardship.

“What we need, in particular, is a clear understanding between the counterparties and a good preparation ahead of the meeting. We definitely need more preparation and fewer meetings.”

Chairman of a FTSE 250 Company

“I believe you get the shareholders you deserve. There are a lot of shareholders with whom you could never have a dialogue. The long-term investors tend to behave consistently, they’re available and they are those that tell you things as they are. With a lot of investor meetings you wonder why they bother. When there is a problem, you do know which investors you can ring. A big difference now is that investors tend to go public more often and much quicker – which is more difficult for companies. What makes it difficult is when the media get behind a small but difficult shareholder. I’d prefer more discussion behind closed doors.”

Chairman of a FTSE 100 Company

“(There is) a fairly small US fund manager, in the top twenty of our shareholders. He studies all the published information through the year. ...He’ll spend 2-3 days just with us. He will meet me and the available senior management. There is continuity. He knows the business; he asks the right questions about the company’s position now and in the future... There is a sensible discussion of hot issues. He is no more focused on today’s share price than I am.”

Chairman of a FTSE 100 Company

Part 1:

Background and findings

Background

There have been great improvements in engagement and stewardship in the twenty years since Sir Adrian Cadbury's report on 'The Financial Aspects of Corporate Governance' and leading up to today's UK Corporate Governance Code for listed companies for which the Financial Reporting Council (FRC) now has responsibility.

The UK now has the world's first code for investor stewardship.

The UK Stewardship Code is a welcome development, but there is a danger that it will become no more than a box-tickers' charter undermining the value that it can bring.

Beneficiaries and clients need their agents to look after their interests and ensure that the companies in which they are invested are accountable. Companies need a core of investors with whom they can have an on-going dialogue. If only a small minority of investors act as stewards their resources are spread too thin to be effective.

For these reasons, the Investor Stewardship Working Party was formed in October 2011. Its purpose is to influence the debate on the development of stewardship and to help implement solutions. Whilst its focus is not to resolve all the major problems of today, such as executive remuneration, it aims to create a framework which could, over time, make such issues easier to resolve.

The research set out to examine how companies judge the quality of stewardship, sources of frustration for companies and what they would like to see change.

During the course of this short project, members of the working party have engaged in 17 dialogues with company chairmen, CEOs, company secretaries, and representatives of the following organisations:

- Association of British Insurers
- Confederation of British Industry
- Financial Reporting Council
- Investment Management Association
- Institute of Chartered Secretaries and Administrators
- Institute of Directors
- Investor Relations Society
- National Association of Pension Funds
- The Hundred Group of Finance Directors.

Findings

From our dialogues with company chairmen, and our own experience, the working party has drawn conclusions which can be divided into issues relating to the **quality** of stewardship:

- the quality of meetings
- the quality of information
- resource limitations

and an issue relating to the **quantity** of stewardship:

- building a critical mass of stewardship investors.

Quality of meetings

Sources of frustration amongst chairmen and non-executive directors (NEDs) are:

Understanding the company

Most of the company chairmen we spoke to want their investors to form a more holistic judgement of the company – about the unique character of the company, its strategy and value drivers, and other issues relevant to that company. They would welcome more investor site visits and other attempts by investors to get a sense of the business, its people, and the real problems and opportunities. Some are surprised how rarely they are asked questions about the human dynamics of the company and how it functions. In support of this, one chairman described his experiences of major value destruction episodes and added “*in each case somebody knew what was going wrong*”. Companies need NEDs with their finger on the pulse and investors need separate access to NEDs and managers to assess the dynamics of a board and the effectiveness of its chairman.

The relationship between the board and the executives is a vital concern for chairmen and deserves more investor attention. Chairmen suggest that investors need to understand how much open discussion of options is taking place at the board. Board evaluation is another vital tool, and chairmen and investors agree that its formalisation has enhanced the understanding of board effectiveness.

To enable investors to judge the company and its character, some chairmen report that they prefer a different type of discussion, distinct from the results meeting with the chief executive – one in which investors have the opportunity to get to know the chairman and NEDs, and understand the character of the company. On the whole they have had a poor response to this idea from investors. The reaction seems to be that there is no need. Yet to these chairmen, it is such meetings which lay the foundations of trust and understanding. It is no good waiting until a major problem has arisen to initiate these discussions.

Some chairmen mentioned that they would like to see active fund managers focus down on smaller portfolios to enable them to understand a company better.

Continuity of relationships

Many of the chairmen want some continuity of relationships so that they can get to know their shareholders better and their shareholders can understand them better. Institutional investors will become more seriously involved in such meetings when there is a crisis, but by then it is too late to have built up the necessary relationship of trust. The most useful meetings are with institutional investors who have a long history of researching the company and engaging with management.

Approach to meetings

Chairmen feel that some investors attend meetings without having given sufficient thought to why they are having the meeting – the meetings often lack a clear agenda and purpose. Chairmen were not always impressed by the credibility of some investors' representatives. Several chairmen were sceptical of the ability of those who had never worked outside the investment world to understand either the dynamics of companies or their strategy. Most however found value in the challenging questions asked. This was not necessarily a matter of age or experience, as some chairmen valued the challenging of strategy by quite inexperienced analysts. Finance directors reported their frustration at the formulaic nature of results meetings. Too often their experience was that the investors present were 'going through the motions'.

Feedback and consistency

Investors rarely provide direct feedback at the end of a meeting, or later, about what they think about the company's strategy or overall approach. Instead feedback was often received via intermediaries such as brokers. Several chairmen said that they preferred direct feedback.

Some companies reported that they found it irritating if investors started to brief the press about their dissatisfaction on an issue which they had not raised with the company.

Companies are frustrated by the divide between governance specialists and portfolio managers. For example, one environmental, social and governance (ESG) specialist was critical of the company's governance practice while apparently unaware of the conversations the company had already held with the portfolio manager. In other examples investors had appeared to follow the advice of a third party to vote against a company's resolution without seeking an explanation from the company, or on some occasions, apparently ignoring a conversation that had previously taken place with the company. Sometimes meetings are assumed by investors to be intended for the governance specialist, whereas the chairman is looking to communicate a holistic view of the company and would like the total view of investors to be represented at the meeting.

Chairmen reported that the most useful meetings with investors tended to be those where both portfolio managers and governance specialists were present. Both company representatives and investors supported the view that ESG issues should be covered at results presentations.

Chairmen and investors alike observed that sometimes the governance/performance divide could be replicated on the company side, where some investor relations managers placed too much focus on market perception of immediate results at the expense of the longer-term business of building trusting relationships with stewardship investors.

“Some long-term investors put the time in. They follow the company and think about the management. They should know about the culture, and voice opinions. What drives me nuts is when you get no response to your communications and you don’t know what the investors think. I need a constructive challenge”

Chairman of a FTSE 250 Company

“There are two sorts of dialogue between an investor and a company. One is with the company’s managers. The other is a dialogue with a chairman about the quality of management. But the latter seems almost always of a secondary importance to investors. I invite shareholders to come and talk to me, but they don’t usually come.”

Chairman of a FTSE 100 Company

“For it to be a useful exchange particularly with larger investors a company should expect that they have done good homework. A large company should expect its major shareholders to have done good thinking about the business issues that they want to discuss with them and outlined their response to what they have heard.”

Chairman of a FTSE 100 Company

“When I was a CEO there was a discussion of financial results and strategy with fund managers. And at the end of the meeting the fund managers would close their books and go to sleep and hand over to the governance people. They had ticked that box and weren’t interested any more. This wasn’t just the case with a couple of institutions – it was the rule. I think this culture still prevails.”

Chairman of a FTSE 100 Company

“When a company is apparently doing well, there are no big issues. But time passes. Something will happen that needs a dialogue and requires adaptive engagement and it is important when that dialogue starts that you are not starting from scratch with investors who have not been previously engaged. You should keep the regularity of contact.”

CEO of a FTSE 250 Company

Quality of information

Improving the interaction between the boards of companies and institutional investors will help both to make better use of each other's time. Getting more and better feedback between them will also help. But better information is needed all the way along the stewardship chain and improvement is particularly needed at two points.

Asset manager stewardship

The most serious shortage of information concerns the information provided by asset managers to asset owners and other potential clients about the amount of stewardship that each asset manager intends to offer. Companies and investors alike acknowledge that not everyone can or should be a stewardship investor. There is a place in the market for trading and liquidity and we acknowledge that many investors will not seek in any way to be stewards. Not every asset owner will want the same level of stewardship activity and not every asset manager will offer the same, but good decision-making requires that there is a solid and comparable basis of information on which each can decide.

The UK Stewardship Code provides a starting point for this. But it does not provide a meaningful basis for differentiation and comparison. Once an asset manager has sought to associate itself with stewardship by becoming a signatory of the code, it is important for potential clients to know how far, and in what particular areas, it intends to exercise stewardship. We need to find some meaningful basis of disclosure which allows each asset manager to describe how little or how much stewardship it intends to undertake. This will help companies to know what to expect from different investors, and it will help asset owners to compare competing bids and match their own stewardship ambitions with those of the asset managers to which they entrust their funds.

Director nominations

In formal terms shareholders delegate authority to directors to act as stewards of the company. But in practice, while directors are nominated and recommended to shareholders via the nomination committees of boards, chairmen see the selection of new directors as their personal responsibility. Most argue that it is impossible to consult with investors about a proposed candidate, because any rejection of that candidate would be damaging to the career of the individual. (There are in fact cases where companies have consulted their most significant shareholders on the suitability of the proposed appointment.)

As already happens in the best cases, the chairman could provide investors with more information about the gaps that need to be filled by new board appointments, the kind of candidates being sought, and the process involved. The best practice by companies is to consult investors early about board succession and to hear their views on what is needed.

There are no best practice guidelines to indicate how shareholders should be involved in the nomination process, and this requires further work.

Resource limitations

Stewardship resources are finite and should not be wasted. As already discussed, many company directors we spoke to complain about the lack of a professional approach to company/investor meetings. If these can be made more productive, this will release some existing resources to further reduce the gap between the demand and supply of stewardship.

Enhanced collaboration between institutions is another way of making these finite resources go further. If, without compromising their competitive advantage, investors can find ways of sharing tasks, or working together in their monitoring of and engagement with companies, they can reduce the cost and may then free up resources that they can use elsewhere.

Collaboration is the subject of a separate principle within the UK Stewardship Code, but in our view UK institutional investors need to do more thinking about how to turn the good intentions of this principle into reality, given the realistic competitive constraints which naturally get in the way of collaboration. More thought also needs to be given to addressing the regulatory constraints, which institutional investors face in collaborating with one another.

There are already well-known arrangements which facilitate investor collaboration once a company has been identified as a particular problem. Investors may work together through the various investor groups that exist, the ABI, NAPF or the United Nations-backed Principles for Responsible Investment Initiative (PRI). One example of two institutions pooling resources is the collaboration between USS and Railpen Investments.

Particular resource constraints apply to the stewardship contribution of index funds (whose contribution to achieving a critical mass of stewardship investors is discussed further opposite). Their business model means that they have to spread resources over a much larger number of companies. It may not be easy to collaborate with competitors at a company level, but there could be opportunities for them to pool resources on policy issues and work to enhance conditions for long-term success in the markets in which they have such an interest.

Building a critical mass of stewardship investors

In law, directors are accountable to all shareholders. In reality, not all shareholders can or indeed should have the same interest in dialogue and engagement with the company.

But looking at it from the point of view of the company, a board needs a critical mass of stewardship investors with whom it can form longer-term relationships and consult over difficult issues.

The composition of this group is not as simple as is often assumed. Sometimes companies decide only to reach out to investors holding more than a given percentage of their shares. But size of holding is not necessarily correlated with value of stewardship contribution.

In our dialogues, we discovered to our surprise that some chairmen do not see index investors as having the potential for stewardship. One went so far as to describe them as “*unengageable with*”. Too many companies are making an untested assumption that index funds are automatically incapable of being stewardship investors.

Both active and passive funds have an interest in stewardship. The first have backed particular companies. The second want the success of all the shares in the index now and into the long-term future. In an increasingly remote and international marketplace for capital, index funds most closely reflect the interest which their clients have in the success of one country’s economy. At a time when ordinary citizens feel increasingly disconnected with the success of the corporate sector, they represent an important link.

Companies should also remember that many large investment houses are not exclusively active or passive. They may have a huge stake in an index through their passive holdings at the same time as having various active holdings. It is better to judge them on how they interact with the company.

We asked chairmen what proportion of the share register needed to be stewardship investors to achieve this. Most chairmen saw a critical mass of investors being between 25% and 35% – although some went as high as 50% – and in most cases they felt it was possible to have regular dialogues with between 10 and 20 investors who represented that holding.

Part 2:

Conclusions and
recommendations

In order to improve the accountability of directors to beneficial owners of shares there is a need for those who do take stewardship seriously to be recognised, acknowledged, and, ideally, rewarded for doing so.

Stewardship is about a lot more than voting. Effective stewardship is about well-chosen engagement.

While there are many more issues to tackle, we have concentrated in our discussions on four issues. First we have found that company chairmen and others would value more access to investors, more in-depth discussion, fewer meetings that are 'a waste of time', better joint handling of issues that reach the media, and better feedback. They are frustrated by investors who present a divided face on company performance and governance issues.

There is therefore an opportunity in all parts of the chain to improve the quality of the engagement and to get better value for the time that is now spent on it by companies and institutional investors. The first step is work together to ensure more purposeful and effective meetings that create value for clients and shareholders.

Secondly, if investors and companies want to make better use of each other's time, there needs to be a more systematic way of collecting the views of companies on the quality of stewardship delivered by their shareholder base. This feedback can then be used to drive further improvements to the dialogue between companies and investors.

The third step is to help recognise, and ultimately reward, the institutional investors which are most effective stewards. Not everyone can or should be a stewardship investor, nor is this particularly desirable in a vibrant market for capital. But efficient markets depend on information and feedback. We therefore need to find some basis for allowing each asset manager to describe in an objective manner, which allows potential clients to make comparisons, how little or how much stewardship they intend to undertake. This lends itself to further verification in the due diligence process undertaken by asset owners.

The fourth step lies with companies. Ultimately there needs to be a critical mass of stewardship investors to which companies can begin to be more accountable. Once companies have defined what represents a critical mass of stewardship investors on their shareholder register they can begin to be proactive in working towards this target. They should extend this to include index funds, which are pivotal to the success of stewardship given their long-term commitment to companies in their index.

Recommendations

Recommendation one: a simple guide to good practice in engagement and other aspects of stewardship so that companies and institutional investors can make better use of each other's time

The best guide would be one that combined the perspectives of companies and their institutional investors. It would be logical for it to be developed in dialogue between institutional investors and relevant professionals involved on behalf of companies – in particular from investor relations, corporate counsel and company secretary functions.

Its purpose is not to replace the UK Stewardship Code but to underpin it with a best practice guide as to how stewardship principles should be implemented. To illustrate the idea, the guide could, among other things, cover the following issues:

For institutional investors to:

- have a clear purpose and proper agenda for each meeting, discussed in advance with the company
- carry out pre-engagement research to identify the unique issues relevant to that company
- have internal discussions in the investment house to identify different perspectives and avoid unintentional inconsistency of approach between different fund managers or between portfolio managers and governance specialists
- give proper feedback either at or after the meeting
- give a positive response to invitations by the chairman and/or NEDs outside of the results cycle to discuss the governance and wider health of the company, and deepen understanding of important issues facing the company. These discussions are seen as essential by chairmen as a basis for understanding a company and its potential to create value for shareholders. (If necessary to meet less often but with more emphasis on depth of understanding.) Where invitations are declined, asset managers should explain why
- give a commitment to listen to the company's explanation on any contentious resolution, and to inform chairmen by letter or email when they vote against resolutions, and to say why, wherever possible, before the vote is cast
- eliminate or better manage the divide between governance and portfolio management. Wherever possible governance should not be dealt with in isolation and whenever it is practical portfolio managers and governance specialists should meet the company together
- develop, in addition, a greater focus on the character and integrity of the company and its board. In time this will require the development of a different level of skills and experience in the teams which support the portfolio managers to achieve the overall exercise of stewardship
- set out clearly, as per Principle 1 of the UK Stewardship Code, how they prioritise engagement to make best use of limited resources
- provide a commitment on behalf of all signatories of the UK Stewardship Code to advise companies when they intend to go public on an issue; and not to engage in talking to the media on issues where they are unhappy with the company until they have fully explored those issues directly with the company.

For companies to:

- understand their major investors' approach to stewardship and how they prioritise their engagement, so as to have realistic expectations of each investor's capacity to engage
- ensure that the best quality information should be made available to their investors in a timely manner so there is less room for misunderstanding. In particular companies should avoid giving surprises during the period between the results announcement and the AGM when investors may have insufficient time to engage
- recognise the need to have two types of discussion with institutional investors – one focused on results, the other on developing a deeper understanding of the company and its character, strategy, integrity and value drivers, and on the effectiveness of its governance and the chairman's approach to board effectiveness
- develop a stronger focus on stewardship within their investor relations function, shifting attention away from immediate share price impacts towards communicating the company's underlying qualities and strengths
- take a holistic and integrated approach to communication with institutional investors by, for example, communicating ESG achievements and risks to all investors and not regard them as matters only for communication with socially responsible investing (SRI) or other niche investors
- recognise that funds best known as being index funds may well have capacity and desire to engage and put in place processes to include them on engagement issues
- accommodate joint meetings where institutional investors can collaborate.

Recommendation two: encourage feedback between companies and investors on the quality of meetings

There are two suggestions:

- to make better use of direct channels for feedback – after every engagement, the company and investors should provide feedback on the experience, ideally in a more systematic way. Companies could do this through their investor relations director or equivalent function
- over time, feedback data could be used at an aggregated level to identify and recognise good stewardship. This process could be reinforced by developing an awards scheme for institutional investors most often 'mentioned in despatches' by companies.

From the process both companies and institutional investors can learn how their activities are perceived and, from this, gain important intelligence on possible changes in approach to enhance the value of future engagement.

Recommendation three: encourage institutional investors who are signatories of the UK Stewardship Code to be more transparent about the degree to which they intend to exercise stewardship

In the UK, the Stewardship Code provides a starting point for this. Not every asset manager will wish to sign the UK Stewardship Code. But once an asset manager has sought to associate itself with stewardship by becoming a signatory of the code, it is important for those who may want to become its clients to know how far, and in what particular areas, it intends to pursue its interest in stewardship.

We have developed, as a starting point for discussion, a 'Stewardship Framework' against which institutional investors can categorise themselves (*see executive summary*).

The framework needs to be tested and further improved in consultation with interested parties, including those experienced in providing assurance statements on non-financial information.

The merit of this approach to disclosure is that it is largely non-judgemental. Each asset manager makes its own choice as to the level of stewardship it aspires to exercise. Each chooses whether to report fund by fund, or to cluster together in its reporting a number of funds which are all covered by the same house approach. Such information would help to encourage institutional investors to be more effectively accountable for how they have matched their statement of good intentions on stewardship with their delivery. It should also provide a basis on which those who take the most trouble to be effective stewards are recognised for all that they do.

Over time, we propose that public statements based on this framework are substantiated and ultimately reinforced by the evolution of AAF 01/06 guidance on internal controls and stewardship. The assurance will act as a deterrent to those who might be tempted to make excessive claims in their categorisation. This provides a more rigorous basis for testing the stewardship claims of different funds and fund management houses.

In this way stewardship activity can become a proper part of the total value proposition offered by institutional investors. Public statements based on this framework will not only help asset owners make more informed decisions. They will also help companies identify long-term engaged shareholders – which is the focus of recommendation four opposite.

Recommendation four: the company ‘Stewardship Profile and Plan’ – how companies can work to achieve a critical mass of stewardship investors on their share register

The ‘UK Stewardship Code’ provides asset owners and other clients with a basis for clear information about the scope of stewardship exercised by different asset managers. The proposed ‘Stewardship Framework’ will, over time, create a more detailed flow of information and so allow comparability between different asset managers and different funds. However, once a ‘Stewardship Framework’ has been adopted and the quality of information on stewardship has started to improve, there will still remain the question of critical mass.

Companies need a body of investors to whom they can be accountable, and with whom there can be a continuity of engagement and accountability. Company chairmen told us that this needs to be between 25% and 35%, and preferably more.

The recommendation is that companies develop a ‘Stewardship Profile and Plan’ for their company.

A starting point could be for chairmen to require their investor relations function to develop these for the company.

The profile would:

- analyse the proportion of shareholders who are at different levels of stewardship in terms of the stewardship categorisation
- give a view of the threshold needed to achieve for the benefit of the stability of the company and in line with its wider strategy
- describe the steps required to achieve and sustain the threshold
- externally report on progress against their target threshold in their annual report.

The plan could also encompass the courting of particular categories of shareowners, changes in communications with and approach towards index investors, new approaches to engaging stewardship investors more meaningfully, including more site visits and in-depth briefings, and even the development of new categories of ownership such as, for example, the employee shareholder. The plan might also build on the different kind of meeting that the chairman and NEDs might want to develop with stewardship investors.

For this plan to be successful, we envisage a shift in the balance of what was traditionally thought of as the investor relations function towards ‘stewardship relations’. While not neglecting tactical investor communications, the key to this role is developing and implementing the ‘Stewardship Profile and Plan’. Once companies start to report on their progress this will provide information which helps to identify whether or not there is a real stewardship gap.

To help follow through the recommendations, some areas have been identified for further study:

- collaboration – a study of ways in which institutional investors could collaborate and ways of reducing the obstacles to that collaboration
- director nominations – a study of current methods by which investors are engaged or consulted in the process of nominating a new chairman or other board member
- the free rider problem – there remains a longer-term question as to how to increase the total appetite for stewardship investing among institutional investors. This would involve more focus on the free rider issue – how to equip those institutional investors who are willing to exercise stewardship with more resources. The aim is to ensure that where all investors benefit from the exercise of stewardship, all investors contribute to it
- remuneration – our dialogues confirmed that current investor engagement is dominated by this issue, but that the time invested in it was yet to result in sufficient improvement and a fresh approach is needed. The study would examine how stewardship investors might work together at the policy level, and how to make their engagement more effective.

To help follow through the recommendations, we are inviting other interested bodies to take action:

- the FRC to incorporate our ideas into their programme to improve the effectiveness of the Stewardship Code
- bodies which represent asset owners and asset managers to promote categorisation within an agreed overall framework
- companies or their representatives to work with us on the development of the concept of the 'Stewardship Profile and Plan'
- others who agree with our recommendations to work together with us in future.

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We would also like to thank all those who participated in these discussions and look forward to continuing the dialogue in the months ahead.

About the organisations represented on the Investor Stewardship Working Party

Aviva Investors is the global asset management business of Aviva plc. The business delivers investment management solutions, services and client-driven performance to clients worldwide. Aviva Investors operates in 16 countries in Asia Pacific, Europe, North America and the United Kingdom with assets under management of £269 billion at 30 June 2011.

www.avivainvestors.co.uk

Email: CorpGovernance.UK@avivainvestors.com

BlackRock

BlackRock is a leader in investment management, risk management and advisory services for institutional and retail clients worldwide. At December 31, 2011, BlackRock's AUM was \$3.513 trillion. BlackRock offers products that span the risk spectrum to meet clients' needs, including active, enhanced and index strategies across markets and asset classes. Products are offered in a variety of structures including separate accounts, mutual funds, *iShares*® (exchange-traded funds), and other pooled investment vehicles. BlackRock also offers risk management, advisory and enterprise investment system services to a broad base of institutional investors through *BlackRock Solutions*®. Headquartered in New York City, as of December 31, 2011, the firm has approximately 10,100 employees in 27 countries and a major presence in key global markets, including North and South America, Europe, Asia, Australia, and the Middle East and Africa. For additional information, please visit the Company's website at www.blackrock.com

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Governance for Owners (GO) is an independent partnership between major financial institutions, shareowners and executives dedicated to adding long-term value for clients by exercising owners' rights. There are three main product offerings – GO European Focus Fund (which invests in European public companies where value can be added through making use of ownership rights and through which we manage c€900m for our clients), GO Stewardship Services (which offers voting and engagement on quoted companies worldwide), and GO Japan Engagement Consortium (which engages with major Japanese companies on behalf of domestic and international institutional investors to improve long-term shareholder returns). GO will shortly launch the TMAM-GO Japan Engagement Fund, which will invest in underachieving quoted companies in Japan and engage with management and boards to improve long-term performance. GO has offices in London, Tokyo and New York.

For additional information, please visit the website at www.g4owners.com

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Ram Trust Services is an entrepreneurial investment management and financial services advisory group operating from Portland, Maine. As an innovative "family office" trust company with a global investment perspective, it provides customized insights to high net worth families, individuals and foundations. Ram Trust believes that being an informed and active shareholder on behalf of its clients makes a difference with respect to risk and performance.

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RPMI Railpen Investments, through its wholly owned subsidiary Railway Pension Investments Limited (“RPMI Railpen”), carries out investment management for the Railways Pension Trustee Company Limited, the corporate trustee of the railways pension schemes with £18 billion in assets at 31 December 2011. Railpen Investments is authorised by the FSA. RPMI provides nationwide coverage from its offices in Coventry, Darlington and London, currently looking after the pension interests of around 500,000 people in the UK on behalf of over 200 clients.

The Trustee Company and its subsidiaries are long-term supporters of better corporate governance and responsible investment. We believe that companies with interested and involved shareholders are more likely to achieve superior long-term financial performance than those without. We strongly support the Financial Reporting Council's UK Stewardship Code published in July 2010 and our full statement on how we apply the code and its seven principles can be found at www.rpmi.co.uk.
Email: press.office@rpmi.co.uk

Universities Superannuation Scheme (USS) is the principal final salary pension scheme provided for academic and senior administrative staff in UK universities and other higher education and research institutions. The fund is the second largest pension scheme in the UK, managing in excess of £32 billion of assets on behalf of nearly 400 participating institutions and over 270,000 members. The majority of the fund's assets are managed in-house by a dedicated team of investment professionals. As an asset owner which takes seriously its fiduciary obligations to its beneficiaries, USS aims to be a responsible and long-term investor.
www.uss.co.uk
Email: responsibleinvestment@uss.co.uk

Tomorrow's Company is the agenda setting ‘think and do’ tank which looks at the role of business and how to achieve enduring business success. We focus on strong relationships, clear purpose and values as the foundation of effective leadership and governance. In our programmes we challenge business leaders around the world to work in dialogue with others to tackle the toughest issues. We promote systemic solutions, working across boundaries between business, investors, government and society.

We believe that business can and must be a ‘force for good’. This in turn requires a strengthening of stewardship by shareholders in partnership with boards of companies. We argue that the Age of Sustainability has begun, and that in the future success and value creation will come from recognising the ‘triple context’ – the links between the economic, social and environmental sub-systems on which we all depend, and the opportunities this brings.

In 2004, we published ‘Restoring Trust – investment in the Twenty First Century’, the report of a business and investor-led inquiry chaired by Sir Richard Sykes. This report drew attention to problems in the workings of the whole value chain that links savers to investors to companies, a theme taken up in the report on equity markets by Professor John Kay.

In 2008 we published 'Tomorrow's Owners – Stewardship of Tomorrow's Company' which drew attention to the importance of investors' stewardship role. Since then we have seen the Walker report, and the welcome development in the UK of the Stewardship Code. In 2011, we published 'Why Stewardship Matters' and the 'Stewardship Manifesto', in which we defined stewardship as *'the active and responsible management of entrusted resources now and in the longer term, so as to hand them on in better condition'*.

We also published four principles of stewardship and explained how, if stewardship were exercised at every link in the investment chain, it could become the golden thread that linked the ordinary individual with their savings to the whole process of wealth creation. You can read or download ['Why Stewardship Matters'](#) and the ['Stewardship Manifesto'](#).

We envisaged the emergence of a critical mass of stewardship investors. A pension fund or life company has a time horizon that stretches into decades. Wealth is created by companies and asset owners want their investments in all asset classes to be earning a return that can be sustained over time. Value for them is about more than the quarterly performance of shares in their portfolio. They need to promote the optimal conditions for future value creation, against the triple context of changing economic, social and environmental conditions. To do this they need, in turn, to identify fund managers capable of bringing the best out of companies and holding boards accountable for their own stewardship. That is what we mean by a stewardship investor.

Further on in the chain investors elect a board of directors. This is the hub of stewardship for any company. Through the work of its Good Governance Forum, Tomorrow's Company has been setting out the agenda for the board, starting with the concept of the Board Mandate (published 2011) and moving on in 2012 to the Boardroom Conversation and the role of the chairman.

We need incentives within the capital markets which promote sustainable outcomes. Tomorrow's Company is tackling this issue in its project on Tomorrow's Stewardship Economy. Underpinning all this discussion is the need to break free from a narrow or fragmented definition of value and to move towards one that is inclusive of all material factors relevant to sustainable value and financial value creation. This is being addressed by our Tomorrow's Value project.

Tomorrow's Company is pleased to have been able to work with such a constructive and imaginative group of stewardship investors in the search for better engagement methods, and for a categorisation of stewardship activity which can be used to make stewardship a meaningful dimension of the buying decisions of asset owners.

www.tomorrowcompany.com

Join the debate at www.tomorrowstewardship.com on www.forceforgood.com

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