Financial Reporting Council

Implementation of the UK Stewardship Code

July 2010

INTRODUCTION AND BACKGROUND

1. In December 2009 the FRC agreed to a request from the then Government to take responsibility for a Stewardship Code for institutional investors, as recommended by Sir David Walker following his review of corporate governance in the financial sector.

2. The FRC agreed to do so because it believes that the Code provides an opportunity to build a critical mass of investors committed to the high quality dialogue with companies needed to underpin good governance. By creating a sound basis of engagement it should lend greater substance to the concept of "comply or explain" as applied by listed companies.

3. The FRC sees the UK Stewardship Code as complementary to the UK Corporate Governance Code for listed companies, as revised in June 2010. Changes have been made to that code to increase the accountability of company boards and encourage them to seek ongoing dialogue with investors; the UK Stewardship Code is intended to incentivise investors to do the same.

4. In January 2010 the FRC consulted on whether it should assume oversight of the Code, whether the code on the responsibilities of institutional investors issued by the Institutional Shareholders Committee (ISC) in November 2009 would form a suitable basis for the new Code, and on operational issues including its coverage, monitoring and review.

5. 81 responses were received to the consultation, including many from fund managers, asset owners, investor representative bodies and providers of proxy voting and other services. Copies of all responses are available on the FRC website[1].

6. There was general agreement that the FRC should be responsible for the oversight and future development of the Code, and with the policy objectives identified in the consultation document, which were to:

    - set standards of stewardship to which institutional investors should aspire, and maintain the credibility and quality of these standards through independent input on the content and monitoring of the Code;

[1] http://www.frc.org.uk/corporate/stewardship.cfm

- promote a sense of ownership of the Code amongst institutional investors in order to encourage UK and foreign investors 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 investors and the boards of the companies in which they invest; and

- secure sufficient disclosure to enable asset managers' prospective clients to assess how they are acting in relation to the Code so that this can be taken into account when awarding and monitoring fund management mandates.

7. The majority of respondents also considered that the code published by the ISC provided an appropriate basis for the Stewardship Code. The FRC agrees with this assessment and has therefore decided in the first instance to adopt the ISC Code with only limited amendments, which are summarised in the next section.

8. As might be expected, there were many proposals for amending or adding to the Code, and many comments on how it should operate. Many of these were valid points that merit further consideration. To address them all properly before adopting the Code would have taken considerable time, and would probably have necessitated a further round of consultation.

9. The FRC is keen to build on the momentum generated by the Walker Review, the ISC's initiative, and the debate on engagement stimulated by the changes to the UK Corporate Governance Code and the consultation on this Code. For this reason the FRC has decided to adopt the Code in its current form. However, the other points raised will be given further consideration and reassessed when the Code is first reviewed.

10. The FSA will shortly begin consultation on proposals to introduce a requirement for authorised asset managers to disclose whether or not they comply with the Code. In the meantime, the FRC would strongly encourage all institutional investors to publish by the end of September 2010 a statement on their website of the extent to which they have complied with the Code, and to notify the FRC when they have done so. Those that have already published a statement of how they have applied the ISC Principles on the responsibilities of institutional shareholders and agents are encouraged to refresh it in the light of the new Code.

11. The FRC would also encourage service providers such as proxy voting agencies that engage with companies on behalf of investors to disclose how they have applied the principles of the Code that are relevant to their activities.

12. The FRC will undertake annual monitoring of the take-up and application of the Code, which will begin in full in the second half of 2011. As with the UK Corporate Governance Code there will also be regular reviews of the content and impact of the UK Stewardship Code. A decision will be made on the timing of the first review following the first full monitoring exercise.

13. In May 2010, after the completion of consultation on the draft Code, the ISC announced that it intended to establish a new senior body, the Institutional Investor Council (IIC), to build a single voice for the institutional investor community and strengthen its profile. The objectives of the Council will include working closely with the FRC in promoting the UK Stewardship Code. The FRC welcomes this initiative, and will discuss means of promoting and developing the Code with the Council when it has been established.

14. There have also been developments at European level since the completion of consultation on the draft Code. In June 2010 the European Commission published a Green Paper on corporate governance in financial institutions in which it indicated that it is considering possible action at EU level on the use of stewardship codes and other measures intended to motivate shareholders to engage with and monitor the financial institutions in which they invest. The Commission also indicated that it would shortly be initiating a review of corporate governance in listed companies, which might be expected to raise similar issues, with a Green Paper to follow in early 2011. The two Green Papers may have implications for the operation of the Code.

THE CONTENT OF THE CODE

15. The FRC has decided to adopt the ISC Code with only minor amendments at this stage. The Code will henceforth be known as the UK Stewardship Code.

16. The amendments are intended to incorporate guidance to institutional investors previously contained in Section E of the Combined Code, and to align this Code with the guidance on engagement provided to companies in the new UK Corporate Governance Code.

17. Specifically, the guidance on Principle 3 (on the monitoring of companies) has been amended to encourage investors to:

    - meet the chairman of investee companies, and other board members where appropriate, as part of their ongoing monitoring and not only when they have concerns;

    - attend the General Meetings of companies in which they have a major holding, where appropriate and practicable; and

    - consider carefully explanations given by investee companies for departure from the UK Corporate Governance Code, and advise the company where they do not accept its position.

18. In addition the FRC has replaced the previous introduction to the ISC Code with a new Preface setting out its objectives of the Code and how it expects it to operate.

19. As noted in the previous section, there were a number of significant issues raised by the consultation which are not addressed in the Code and which merit further consideration. These include, for example, whether institutional investors should disclose their policies on stock lending, arrangements for voting pooled funds, and the nature of the information to be disclosed on voting records. The FRC will carry out further work on these issues in advance of the monitoring exercise planned for the second half of 2011.

WHO SHOULD APPLY THE CODE?

20. The Code is addressed in the first instance to those firms who manage assets on behalf of institutional investors. The FSA is expected to begin consultation in July 2010 on proposals to introduce a "comply or explain" disclosure requirement that would apply to those firms authorised by the FSA to manage assets on behalf of institutional investors. The FRC expects those firms to disclose on their websites to what extent they have complied with the Code, and how they have done so. Institutions that manage several types of fund need only make one statement.

21. However the responsibility for an effective engagement process does not rest with asset managers alone. The actions of other investors can have a significant beneficial impact on the quality and quantity of engagement with UK companies, and the FRC encourages all institutional investors to report if and how they have applied the Code, on the same basis as asset managers.

22. Pension funds and other owners may not wish to become directly involved in engagement but they can contribute by, for example, mandating their fund managers to do so on their behalf and scrutinising with care their reports on engagement.

23. Pension funds have an existing obligation, under the 2000 SRI Pensions Disclosure Regulation, to disclose "the extent (if at all) to which social, environmental and ethical considerations are taken into account in their investment strategies". In addition the 2007 Myners Principles encourage them to report on the ISC Principles on the responsibilities of shareholders and agents, a precursor to the Stewardship Code. A statement on both should form part of their Statement of Investment Principles.

24. The FRC welcomed the guidance issued by the National Association of Pension Funds (NAPF) in March 2010 on how pension funds could apply the ISC Code[2], and is encouraged to note that two-thirds of pension schemes surveyed by the NAPF believe they will devote more time to scrutinising the actions of investment managers on engagement issues in future[3].

[2] 'Pension Funds and the ISC Code – A Practical Guide'; National Association of Pension Funds; March 2010.
[3] 'Pension Funds' Engagement with Companies'; National Association of Pension Funds; May 2010.

25. The FRC also hope that investors based outside the UK will commit to the Code. It is recognised that, in practice, local institutions usually take the lead in engagement. But support from overseas investors with significant holdings can make a real difference.

26. Many of the responses to the consultation considered that proxy voting agencies should be encouraged to report against the Code. Principle 1 of the Code states that institutional investors that make use of proxy voting and other advisory services should disclose how they are used. The FRC agrees that it would be desirable for these agencies in turn to act in a way that is consistent with the Code, and would encourage them to disclose how they have carried out the wishes of their clients by applying the principles of the Code that are relevant to their activities.

HOW WILL THE CODE OPERATE?

27. The Code does not constitute a requirement to engage. The FRC recognises that it is legitimate for some institutions to choose not to engage with companies if that does not form part of their investment strategy, or for other reasons. As with the UK Corporate Governance Code, the Code should be applied on a "comply or explain" basis.

28. In reporting terms this entails providing a statement on the institution's website containing:

    - a description of how the principles of the Code have been applied, and
    - disclosure of the specific information listed under Principles 1, 5, 6 and 7; or
    - an explanation if these elements of the Code have not been complied with.

29. The FRC recognises that not all parts of the Code will be relevant to all institutional investors. For example, smaller institutions may judge that some of its principles and guidance are disproportionate in their case. In these circumstances investors and providers should take advantage of the "comply or explain" approach and set out why they consider this to be the case.

30. Specifically, the "explain" option means that overseas investors who follow other national or international standards that have similar objectives should not feel application of the Code duplicates or confuses their responsibilities. Disclosures made in respect of those standards can also be used to demonstrate the extent to which they have complied with the Code. In a similar spirit, UK institutions that apply the Code should use their best efforts to apply its principles to their overseas holdings.

31. Disclosures made in relation to the Code will assist companies to understand the approach and expectations of their major shareholders. They will assist those issuing mandates to asset managers to make a better informed choice, assist managers to understand the expectations of currents and potential clients, and may help investors interested in collective engagement to identify like-minded institutions.

32. For these benefits to be realised this information needs to be readily accessible. The FRC therefore proposes to list on its website all investors that have published a statement of the extent to which they comply with the Code, and asks that they notify the FRC when they do so[4] and whenever the statement is updated. The FRC will provide a link to the statements but will not comment on their contents, and inclusion on the website should not be interpreted as an endorsement by the FRC of the accuracy of the statements or the policies pursued by individual institutions.

33. The FRC will make this list available on its website from October 2010 and would encourage all investors to publish statements on their website and notify the FRC by that date.

34. The FRC would also encourage each institution to name in its statement an individual who can be contacted for further information and by those interested in collective engagement.

[4] Please send details to stewardshipcode@frc.org.uk

REPORTING TO CLIENTS

35. As well as reporting publicly on their engagement policies and activities, it is important that asset managers report to their clients on how they have discharged their responsibilities. This is covered in Principle 7 of the Code.

36. The guidance on Principle 7 recommends that asset managers consider obtaining an independent audit opinion of their engagement and voting processes. A number of respondents to the consultation exercise expressed concerns that this might lead to costly verification exercises and "second guessing" of engagement policies.

37. Guidance on this issue is currently being developed by a working group of the Institute of Chartered Accountants in England and Wales (ICAEW) in conjunction with a stakeholder panel including members drawn from fund managers, pension funds and auditors, and will be issued for consultation later in 2010. Asset managers may wish to wait until the guidance has been finalised before considering whether to comply with this part of the Code. Overseas institutions will want to consider an approach to verification that is consistent with the approach in their own jurisdiction.

38. The working group's aim is to build upon the Audit and Assurance Faculty (AAF) 01/06 guidance which has helped to deliver market-led independent assurance reporting over a wide range of investment management related activities. Key features will include a focus on those aspects of the Code that are objectively verifiable and keeping the cost down. Work is also taking place to ensure that the reporting is based on International Standards on Assurance Engagements.

MONITORING AND REVIEW

39. The consultation document sought views on how monitoring of the application of the Code should be carried out and by whom, and which activities and information should be monitored. A wide range of views were expressed in response, and the FRC will undertake further work to develop a proposed approach to monitoring. It is envisaged that the first full monitoring exercise, looking at the take-up and application of the Code, will be carried out in the second half of 2011.

40. As an interim measure, the Investment Management Association (IMA) is continuing with its regular engagement survey, which is being tailored to cover adherence to the Code by those institutions that sign up, and is introducing some independent oversight to the survey process. Its intention is that this will review adherence in 2010 and provide initial benchmarking data. The FRC is liaising with the IMA on this and is to chair the steering group set up to oversee this survey, without prejudice to the approach that may be followed in future years.

41. As with the UK Corporate Governance Code, it is envisaged that the FRC will lead regular reviews of the content of the Code to consider whether changes are needed to reflect developments in good practice or in the structure and operation of the market and changes to the broader regulatory framework.

42. It would be premature to set a timetable for review before the Code has even come into effect. As a new code it will need time to bed in before its effect can be measured, but because it is a new experience for those operating and applying the Code – including the FRC – there is a danger of unintended consequences which may need to be addressed in order to ensure the Code is able to work as intended.

43. The FRC will take a view on this issue following the first full monitoring exercise in the second half of 2011, in the light of the findings of that exercise, further consideration of issues raised in response to the recent consultation, and other relevant developments, including any proposals arising from the European Commission's Green Papers on corporate governance.

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