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Armstrong Bonham Carter's response to the Financial Reporting Council's consultation on the Stewardship Code for Institutional Investors April 2010

Armstrong Bonham Carter (ABC) is delighted to provide some views on the proposed Stewardship Code (SC) for Institutional Investors and has commented as per Appendix A of that consultation document.

Overall:

ABC notes that the real crux of the Stewardship Code lies in Principle 3 of the Institutional Shareholders Committee Code (ISC Code). This principle states that institutional investors should monitor their investee companies. The guidance provided is correct in that institutional investors should check whether the investee company board and sub-committee structures are effective. But there is no further guidance as to what is an effective board or sub-committee. The current Combined Code of Corporate Governance and the proposed new UK Corporate Governance Code also does not provide any definition of an effective board.

So there is a real risk that a myriad of different definitions will continue to be used by institutional investors in their monitoring processes and boards will continue to be confused by the messages from the engagement with their shareholders. Hence despite all this effort by the Institutional Shareholders Committee, Sir David Walker and the FRC and the consequential raised expectations that relations between boards and their shareholders could radically improve, nothing is likely to change.

Section 1:

- The proposed objectives are reasonable subject to the following caveats.
- Institutional investors should always aspire to meet the needs of their clients and thus it is they, the beneficial owners, who should set the requirements of their appointed managers. So whilst the FRC is in a position to set the standards of stewardship, it is an imperative that the beneficial owners agree to these standards. Without this endorsement, the credibility of these standards will be undermined. Assuming that beneficial owners do believe adherence to these standards is in their best interests, then the credibility and quality of these standards will be enhanced by independent and appropriate input on the content and monitoring of the SC.
- A real sense of ownership of the SC amongst institutional investors will depend on the beneficial owners requiring that their agents do comply with the SC.
- If the institutional investors do feel they are required by their beneficial owners to comply with the SC then it is an imperative that engagement is not just linked to, but integrated into, the investment process.
- Adherence to the SC should not just improve communication but also allow boards to be aware of whether they have the support of their shareholders in achieving any declared aim via the implementation of the announced strategy and component plans.

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- If beneficial owners believe it is in their best interests to ensure their appointed institutional investment manager should engage effectively, then these managers should ensure sufficient information is available both prior to, and during appointment, in order to assess the effectiveness of their engagement. The FRC's efforts to provide suitable standards of disclosure will be of value to these owners.
- It is ABC's view that the FRC should accept oversight of the Code, both in current and future form as it is a suitable, independent and authoritative body capable of administering the task. Ideally, if a sole body or organisation existed to represent all beneficial owners of all equity investment products and services covering pension funds, insurance products investment trust, unit trust etc., this could prove to be a more effective owner of the SC. But at present ABC is not aware of any such body.
- Whilst some beneficial owners may not require their institutional investors to comply with the SC or explain their reasons for not doing so; a comply or explain basis is an optimum solution.

Section 2: No comment.

Section 3:

- ABC believes it is the prime responsibility of institutional investors to act in accordance of the mandates awarded to them by their clients or beneficial owners. If these owners do not believe it is in their interests to engage, then their agents should explain that they cannot adhere to the SC. ABC also recognises that some institutional investors may not be convinced that more active engagement will necessarily lead to improved investment returns, after the costs of that engagement activity and may persuade their clients or prospective clients of the merits of that argument.
- If there are other bodies such as voting agencies or investment consultants that are either opining on corporate governance standards and practices of boards or evaluating the engagement policies and practices of institutional investors, then they should be encouraged to commit to the spirit of the SC and describe how their business model and practices do so in their company brochures and on their websites.

Section 4:

- The responsibilities for engagement of institutional investors to the beneficial owners (whose interests they represent) should be laid out in the mandate that the latter have given to the former. If beneficial owners determine that they require engagement as part of the mandate awarded, then they should stipulate what is required. Hence the FRC's provision of the SC will provide some guidance for the beneficial owners. This will need to be supported by the investment consultants.
- Overall, the ISC Code does cover all the relevant responsibilities within the seven principles.
- If UK listed company boards were true to the principles of accountability and transparency, institutional investors would be more easily persuaded to be clearer over their support for these boards. But whilst this is not consistently provided by UK listed companies (where many boards tend to operate with a high degree of opacity), there are no responsibilities for engagement of institutional investors to the UK listed companies in which they invest and thus the ISC Code does not have to cover this.
- The only responsibilities are those of the institutional investors and their agents towards their clients which are sufficiently clear.

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- The risk of the use of principles is that in under-specifying engagement, the mean standard of engagement does not achieve the desired expectations and thus complying with the ISC Code does not lead to improved standards of engagement. Boards of UK listed companies and institutional investors will remain at odds with one another over the quantity and quality of their engagement. This is the current and real risk, not simply one of over-specifying.
- The real crux of the ISC Code is in principle 3: Institutional investors should monitor their investee companies. The guidance is correct in that institutional investors should check whether the investee company board and sub-committee structures are effective, but there is no further guidance as to what is an effective board or sub-committee. In addition, the current Combined Code of Corporate Governance and the proposed new UK Corporate Governance Code also does not provide any definition of an effective board. At the very least, this risks a myriad of different definitions being used by institutional investors in their monitoring processes and confusing the boards of their investee companies, having engaged with their shareholders. For example, one investor may feel a board is ineffective because there is an executive chairman, whereas another may not view this as an issue. Also there are unresolved areas of confusion over such things as: do you need to monitor all equity holdings irrespective of size, when should you meet companies and with whom, what should be discussed at that meeting, when does an institutional investor intervene and how, when should that investor escalate by sharing its concerns with the company, the broker or with other shareholders, when should an investor use its voting powers and when would it be appropriate to sell?
- As a consequence of the lack of clarity on how to monitor, it is not evident how institutional investors would be able to assess the effectiveness of their engagement process.
- ABC believes the ISC Code more than covers the content of Section E of the Combined Code.

Section 5:

- Institutional investors who wish to comply with the ISC Code disclosing their engagement policy and how this was fulfilled over the last year. This should be updated, at the very least, after each AGM season.
- The implication of a comply or explain basis would suggest a self-reporting mechanism, such as a survey, would be the most appropriate.
- As above, periodic surveys requesting comments on the operation and the content of the Code from institutional investors, agents, beneficial owners and boards of listed companies would be the most appropriate.
- The disclosure of specific information should consist of the policy and the actions taken in implementing that policy. This should all be subject to public disclosure, unless there is a particular engagement issue still ongoing which may influence the share price.
- ABC views the structure of the ISC Code as suitable enough to allow reporting against it on a comply or explain basis, subject to ABC's previous comments on the lack of clarity of the monitoring process.
- ABC does not believe that auditors or other professional accountants have suitable skills to evaluate the effectiveness of engagement policies and practices. But an independent evaluation of these policies and their actual practices would be useful to ensure that compliance with the ISC Code is maintained, best practices can emerge and then be shared, which over time can improve the ISC Code.
- IMA Code is a suitable survey, but as with many surveys, it is not subject to verification of the data submitted.
- ABC agrees that the ISC Code should be subject to periodic review for its effectiveness.