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Your ref: Stewardship Code

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Dear Susannah

CONSULTATION ON A STEWARDSHIP CODE FOR INSTITUTIONAL INVESTORS

ICAEW is pleased to respond to your request for comments on the consultation paper *Consultation on a Stewardship Code for Institutional Investors* published by the Financial Reporting Council (FRC) in January 2010.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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ICAEW REPRESENTATION

CONSULTATION ON A STEWARDSHIP CODE FOR INSTITUTIONAL INVESTORS

Memorandum of comment submitted in April 2010 by ICAEW, in response to the Financial Reporting Council consultation paper *Consultation on a Stewardship Code for Institutional Investors* published in January 2010.

Contents	Paragraph
Introduction	1 -
Who we are	2 - 3
Major points	4 - 13
Responses to specific questions	14 - 54

INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the consultation paper *Consultation on a Stewardship Code for Institutional Investors* published by the FRC.

WHO WE ARE

2. ICAEW operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, we provide leadership and practical support to over 134,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. We are a founding member of the Global Accounting Alliance with over 775,000 members worldwide.
3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. We ensure these skills are constantly developed, recognised and valued. This response has been drafted after consultation with the ICAEW's Corporate Governance Committee which includes representatives from the business and investment communities. We have also received input from our Audit and Assurance Faculty in relation to paragraph 5.21 of Section 5 Reporting, Monitoring and Review.

MAJOR POINTS

Support for the initiative

4. We are supportive of the concept of a Stewardship Code as a mechanism to state recognised best practice and believe that it can help to bring about more effective engagement between companies and shareholders. A Stewardship Code could bring about real improvements in the governance of UK listed companies. Experience with other codes would indicate that they become more effective over time as they are established and improved.
5. We believe that a Stewardship Code can bring about greater understanding and greater transparency of the responsibilities of asset managers and owners which could benefit the ultimate owners who are largely unrepresented in the investment chain.
6. It is important that the Stewardship Code is seen as added value and does not create a commercial disadvantage to UK institutional investors who are in the minority when looking at the whole of the beneficial ownership of the UK market.
7. We see independent assurance to be potentially helpful to the beneficial owners of shares. We are supportive of independent assurance on engagement and voting processes but we believe that this should be voluntary and not mandatory. We believe the market will value the assurance.
8. We fully support the 'comply or explain' nature of the Stewardship Code as it allows investors to use their best judgement on the nature and extent of their disclosure. Much of the Stewardship Code simply articulates an already expected best practice by market participants.
9. We support the principle that there should be monitoring of compliance with the Stewardship Code but we do foresee difficulties in relying exclusively on existing surveys undertaken without an independent monitoring mechanism.
10. Some investors are already subject to mandatory requirements on stewardship under existing laws. Pension funds for example are required under section 244 of the Pensions Act 2004 to

report to their beneficiaries on their management of the scheme's assets via the Statement of Investment Principles (SIP) and to disclose their policy on engagement to scheme members either in the SIP or in their annual report. There may be utility in reviewing this existing disclosure to ascertain whether it could be widened in application.

11. We agree (but note that this is subject to separate consultation) that the FSA should require institutions that are authorised asset managers to disclose on their website whether and, if so, how they commit to the Stewardship Code.
12. The latest figures from the Office of National Statistics (Statistical Bulletin: Share Ownership Survey 2008) show that during the 1980s and 1990s the proportion of shares owned by investors outside of the UK has increased substantially. The past decade has continued to see increases in overseas holdings, with holdings in 2008 standing at 41.5 per cent of the UK stock market. This is in marked contrast to 1990 when the equivalent overseas holdings total was just 11.8 per cent. Over the same period the proportion of shares held by insurance companies and pension funds combined was 52.1% in 1990 but in 2008 this had decreased to 26.2%. In this context the Stewardship Code is by its very nature limited to a relatively small section of the UK shareholding community. This is not a reason why a Stewardship Code should not be developed but it is important to remain realistic about the extent to which a Stewardship Code can influence behaviours of the market as a whole. There is much to be gained by simply stating recognised best practice and decent behaviour within the investor community. The real challenge is how this can be extended to the whole of the investor community and not just a small part of it.
13. However, this is not the first initiative in this area and if the Stewardship Code is to be the basis for a real and substantial change of behaviours the Stewardship Code alone may not be sufficient without addressing conflicts within the investment chain. We think this is an area where additional research could be extremely useful.

RESPONSES TO SPECIFIC QUESTIONS/POINTS

Section 1: Introduction

Views on the policy objectives against which to judge a Stewardship Code (section 1.14)

14. The benefits to be gained through independent input on the content and the monitoring of the Stewardship Code is a worthy policy objective but to be effective and to be capable of being judged year on year the monitoring must be effective. The policy objective to ensure that engagement is closely linked to the investment process within the investment firm is a good one but it would be helpful to explore exactly how this policy objective could be achieved in practice and how it can be judged as effective.

Views on whether the FRC should accept oversight of the Code in its current form, or whether amendments should be made before the FRC does so (section 1.16)

15. We see no reason why the FRC should not accept oversight of the Stewardship Code in its current form subject to the changes that will arise as a result of the current consultation. As the FRC has undertaken to review the operation of the Stewardship Code on a regular basis, amendments and refinements can be made over the course of time in a planned and thought out way once evidence of the operation of the Stewardship Code is considered and reviewed.

Views 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 (section 1.17)

16. One major investor group who does not appear in the Institutional Shareholders' Committee (ISC) Code is the public sector. Public sector holdings of shares have risen sharply in recent times due to the Government intervention in financial companies in 2008. In 2006 less than

0.1% of shares in UK quoted companies were held by the public sector. By the end of 2008 this figure had increased to 1.1% of all shares in UK quoted companies. We see no reason why the public sector holdings should not be encouraged to apply the Stewardship Code on a 'comply or explain' basis and believe that this investor group should be included within the scope of the Stewardship Code.

Views on costs and benefits arising from the proposed Code and the different options for reporting and monitoring (section 1.19)

17. We have no detailed observations to make on the costs and benefits arising from different options for reporting and monitoring and believe that this is a matter for institutional investors to comment on as they will bear the brunt of the additional costs.
18. However, we make the observation that the advantages in terms of market stability that could flow from better shareowner communication could, if the communication were effective, far outweigh the associated costs.

Section 3: The Coverage of the Code

Are there any barriers or other reasons that would prevent or discourage all UK institutional investors to apply and report on the Code (section 3.6)

19. There will be cost implications for UK institutional investors to apply and report on the Stewardship Code but these should not prevent or discourage adherence to the Code.

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 (section 3.8)

20. We believe that all those involved in the investment chain should be encouraged to commit to the spirit of the Stewardship Code. This could be done by including a Stewardship Code provision that requires UK institutional investors (or those subject to the Stewardship Code) to require those that they contract with for services to comply with the relevant sections of the Stewardship Code. UK institutional investors could therefore make it a condition of engagement with any voting agency or investment consultant that they would abide by the spirit of the Stewardship Code.

Views on any barriers or other potential difficulties for foreign shareholders seeking to engage with UK companies (section 3.13)

21. We cannot foresee any barriers or difficulties for foreign shareholders seeking to engage with UK companies or indeed for UK companies to engage with their overseas shareholders. Indeed, the way the ISC Code has been drafted positively encourages dialogue with overseas fund managers and sovereign wealth funds.

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?

22. The responsibilities for engagement of institutional investors to the beneficial owners whose interests they represent are considerable. The ISC Code is light on articulating these responsibilities and it would be improved if key responsibilities were more clearly highlighted. Principle 7 as drafted is sufficiently broad but the accompanying guidance could be expanded to move away from simply a contractual solution. It seems too big an issue to simply say that this 'should be a matter for agreement' between agents and their principals especially when the bargaining position of agent and principal are not equal. Annual reporting on policy and execution by principals to their end-investors is a bare minimum standard. The guidance on

transparency which is included in the Stewardship Code is more about what should not be disclosed rather than what should be disclosed. This is perhaps a missed opportunity.

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

23. The responsibilities for engagement of institutional shareholders to the UK listed companies in which they invest are not sufficiently articulated in the ISC Code as currently drafted. The ISC Code talks in language of 'monitoring' rather than 'dialogue'. The Stewardship Code could focus more on promoting an alignment of interests, through dialogue, rather than seeking to be simply a monitoring mechanism.
24. Monitoring is clearly part of the responsibilities for engagement of institutional shareholders but it should not be viewed as merely a mechanism to decide when dialogue is desirable.
25. A main responsibility should be to gain much greater clarity with respect to long-term objectives. This is not adequately reflected in the ISC Code at the moment. Creating an understanding of both investee and investor long term objectives should be a joint responsibility which is reflected in the Stewardship Code. As drafted, Principle 3 is short-term in outlook and seems to be a charter for box-ticking rather than a platform for real engagement.
26. Three key features are important to creating an understanding of shareholders' interests in investee company long-term objectives:
- the level of commitment demonstrated within the investor;
 - the amount of resources devoted by the investor to engagement with investee companies; and
 - what strategies the investor adopts to pursue dialogue with investee companies.
27. Disclosure and transparency on these matters would be extremely helpful and could be usefully included within the guidance in Principle 3.

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

28. We do not believe that the responsibilities of the different parts of the investment chain are sufficiently clear and think that any advancement made in this area would be useful.

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

29. The ISC Code lacks a level of specification in the area of coherence between the portfolio management and governance functions within an investor and it would be useful if some guidance were included in this area.

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

30. The guidance in Principle 3 could be improved to include detailed guidance on best practice for achieving enhanced transparency as mentioned above. There is nothing in the ISC Code concerning the coherence between the portfolio management and governance functions within the investor organisation. The advantages to be gained when there is an effective exchange between analysts and governance professionals within the investor organisation is a critical part of this debate and this is not reflected in the ISC Code. The dangers involved in a 'silo' mentality are well understood and in this structural aspect the ISC Code could address some of these issues or at least highlight them. Institutional investors are best placed to assume effective governance over their investee companies when there is coherence between the portfolio management and governance functions.

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

- 31.** The ISC Code does not emphasise the ‘mutual understanding of objectives’ which underpin Section 2 of the Combined Code. It is fundamental that a mutual understanding is accepted as a driving principle because it is only in this way that real governance changes can be brought about.
- 32.** The ISC Code lacks a holistic view and the overall tone could be seen as implying a compliance approach rather than the avoidance of box-ticking for example, while the idea of obtaining an independent audit or opinion on engagement and voting processes may be helpful, this cannot substitute for effective dialogue between companies and investors. It is also a pity that attendance by institutional investors at AGMs, where appropriate and practicable, has not been encouraged in the ISC Code. We understand the constraints on institutional investors’ but nonetheless institutional investors attendance at general meetings does enhance any meeting considerably and publicly evidences investors’ engagement. It is a pity that this has not found a place in the ISC Code.

Section 5: Reporting, Monitoring and Review

Views on the information that institutional shareholders should disclose publicly and that they should report to clients (section 5.2)

- 33.** We view the reporting by institutional shareholders to their clients as being fundamentally more important than merely the public disclosures of policies. However, we note and agree with the public policy objective of disclosure as a means of promoting better understanding and communication between companies and investors in order to help the investment chain to operate more effectively.
- 34.** Clear and transparent reporting to clients is fundamental as it is the corner-stone that enables clients to make an assessment of whether their mandates are being met and that fund managers are engaging with companies on their behalf. It may also facilitate better and more informed decisions by existing and prospective clients in their decisions about future fund management mandates.

Views on the arrangements that should be put in place to monitor how institutional shareholders apply and report against the Code (section 5.2)

- 35.** There is a need for the Stewardship Code to be monitored effectively. Any monitoring arrangements should be independent. It would be appropriate if the FRC, either on its own or in conjunction with the investment industry, could develop new, or build on existing, monitoring arrangements to include an element of independent oversight.

Views on the arrangements for reviewing the operation and content of the Code (section 5.2)

- 36.** We are supportive of the approach proposed that the FRC review the Stewardship Code every two to three years by way of public consultation.

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 (section 5.3)

Views on whether public disclosure of the information summarised is appropriate and useful, and whether other information might also usefully be disclosed (section 5.6)

- 37.** We welcome the proposals that institutional investors should publicly disclose their policies on how they will discharge their stewardship responsibilities; their conflicts of interest policy; their policy on collective engagement and their voting records. We interpret this to mean that the

actual policy documents should be available on their websites as well as a detailed disclosure on implementation during the course of the year.

38. The ISC Code guidance on what the policies should include is useful although by no means comprehensive. More guidance on this may be useful for some investors, particularly overseas ones.
39. Whilst it is important to have the policies on these matters disclosed, in many ways what is more important is information on how these policies have been implemented in a meaningful way. By being transparent about the ways the various policies have been implemented in practice, real governance can be improved. We do not believe that overall the quality of governance will be increased significantly simply by having policies published on websites.
40. Other information that would be useful to have in the public domain would be:
 - statistics on numbers of actual engagements made with investee companies (in this way engagement can be compared across investors);
 - details on how stewardship activities within the investment institution have been integrated into the wider investment process;
 - statistics on actual voting;
 - details (where confidentiality restraints permit) of any successful interventions;
 - details of the methods actually used to monitor investee companies; and
 - details of all third party intermediaries used in the voting and governance process.

Views on the structure of the ISC Code and on the best way to encourage reporting against it on a 'comply or explain' basis (section 5.10)

41. As to how 'comply or explain' should operate we would favour a statement of how the investor firm has applied the principles within the Stewardship Code in such a way that would enable clients and beneficiaries to evaluate how the principles have been applied, with an explanation of non-compliance against each of the principles where applicable. We do not think that a simple statement that an investment firm has followed the Stewardship Code or an explanation of an alternative strategy would be sufficient. Such a simple statement could lead to boiler-plate statements without any meaningful disclosure.

Views on the proposals in the 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 (section 5.21)

42. We are in agreement with Principle 7 of the ISC Code that institutional investors should report periodically (at least annually) on their stewardship and voting activities and that the specific information reported should be a matter for agreement between agents and their principals.
43. The guidance that directs those signing up to the ISC Code includes a section asking them to consider obtaining an independent audit or opinion on their engagement and voting processes having regard to the standards in AAF 01/06 (*Assurance reports on internal controls of service organisations made available to third parties*) and SAS 70 (*Reports on the processing of transactions by service organisations*). The guidance goes on to state that the existence of such assurance should be publicly disclosed.
44. As the consultation document points out the most relevant existing standard is AAF 01/06 which is produced by the ICAEW Audit and Assurance Faculty. AAF 01/06 is based on the International Standard on Assurance Engagements (ISAE) 3000. Also relevant is AAF 02/07 (*A framework for assurance reports on third party operations*) which provides overarching guidance.
45. There are practical difficulties in mandating an independent assurance reporting model for the Stewardship Code as a whole but we believe that, as the Stewardship Code is currently

drafted, the independent assurance reporting model could apply to those parts of the Stewardship Code where objective assessment is possible. In particular, some of the drafting in the Stewardship Code would make independent assurance difficult because many of the concepts would require a subjective judgement. For example what would constitute a 'robust policy' for the purposes of Principle 2 or 'monitoring' for the purposes of Principle 3.

46. As currently drafted Principles 1, 6 and 7 lend themselves to being capable of independent assurance together with the third bullet of Guidance in Principle 2 and the second bullet of Guidance in Principle 3.
47. There are a number of small but significant changes to the drafting of the Stewardship Code which would make a form of independent assurance possible. In particular, it may be helpful to group the obligations to maintain differing policies under one principle so that the existence of each policy could be verified. It would also be helpful to include references to the existence of procedures to comply with the policies as these items can be verified.
48. Following the approach that has underpinned the development of AAF 01/06 and AAF 02/07 to date, representatives of the ICAEW Audit and Assurance Faculty have already had a first meeting with relevant stakeholders including various bodies, investment managers and audit firms to discuss the report wording and criteria. This meeting achieved a high level of agreement on those principles and supporting guidance which are objectively verifiable (and thus conducive to assurance reporting) and those which are too subjective for assurance reporting.
49. We are of the view that any regime involving AAF 01/06 and AAF 02/07 should be voluntary and subject to individual agreement between agents and their principals, allowing market forces to operate. In reality such work will be restricted to those areas that can be objectively verified where there are economic benefits to be obtained from seeking independent assurance in this way.
50. We would be happy to engage further with the FRC and to include an observer from the FRC at future meetings to discuss the application of AAF 01/06 and AAF 02/07 in the context of the Stewardship Code and to explore the detailed drafting that would make independent assurance workable in this context.

Views on the merits of the current IMA survey and other possible approaches to monitoring the overall application of the Code (section 5.21)

51. We believe that it is essential that there is an independent oversight of the process to monitor adherence to the Stewardship Code. As the FRC does not currently monitor listed companies' adherence or compliance with the Combined Code/UK Corporate Governance Code we see no logic in the FRC itself attempting to monitor institutional investors' adherence to the Stewardship Code although we would have no objection to the FRC doing so.
52. We would be in favour of the IMA survey being used as a model for overall application of the Stewardship Code provided that some industry agreed form of independent oversight was introduced. Also thought would need to be given to extending the survey to include more market participants than are currently represented by the survey.
53. It would be appropriate if the FRC and the investment industry could develop new monitoring arrangements which include an element of independent oversight.

Views on the proposed approach to reviewing the Code (section 5.22)

54. We are supportive of the approach proposed that the FRC review the Stewardship Code every two to three years. Public consultation with those applying the Stewardship Code and any other interested parties to focus on the overall effectiveness of the Stewardship Code and on the 'comply or explain' nature of disclosure would be a helpful development. We believe that

this will help shape the Stewardship Code over time and allow market participants to raise any issues at a fixed point in time as governance practices within the investor community develop.

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