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To: Stewardship Code
Subject: Consultation on a Stewardship Code for Institutional Investors

Consultation on a Stewardship Code for Institutional Investors

Thank you for providing KPMG with the opportunity to respond to the above consultation paper. We welcome the objective of the proposals to bring about improvements in the stewardship of UK listed companies by institutional investors. We support the concept of a Code which encourages best practice and effective engagement between companies and shareholders.

We have set out in Appendix 1 our responses to the specific questions presented by the consultation paper.

Our key area of concern is whether or not the current proposals contained within the consultation will be sufficient to bring about the change in behaviours that the Walker Report wishes to achieve. The Code, as proposed, has been developed from the Institutional Shareholders Committee Code (ISC Code) principles that have been in existence for a number of years. As drafted, the Code does not differ greatly from the ISC Code. According to the Investment Management Association (IMA), approximately two-thirds of UK equity investment managers already claim compliance with the ISC Code.

The current proposals may have the benefit of being developed out of current industry practice, but the FRC could consider more radical approaches to stewardship to further address the concerns noted in the Walker Report. These could include; consideration of Swedish style nomination committees, shareholder input to Board effectiveness reviews, a principal shareholder role and / or an investors forum (facilitated by investee firm) to encourage greater communication prior to general meetings. We believe that such developments would be worthy of further consultation.

The Code, as written covers UK institutional investors, who comprise only a limited portion of investors in UK listed entities. Capital markets are global in nature and effective stewardship should recognise this. As such, in order to fully achieve the goals set out in the Walker Report, a more global approach may be required. Global application of the Code could be encouraged but achievement of the objectives would be more likely if other jurisdictions are consulted. The FRC should seek a common framework with other jurisdictions regarding the responsibilities of institutional investors.

We would like to see the FRC continue to engage with institutional investors and investment managers to gauge the level of support for the Code; and work with these parties to ensure that the final Code has their full backing. Without the active participation and continued support of these parties the Code will not achieve its objectives. This could be assisted by the FRC sponsoring a working group to develop and refine the ISC Code. We would be willing to participate in such a group.

We have noted, in Appendix 1, some areas of concern regarding the ability to provide or obtain independent assurance on several of the principles of the ISC Code. This is detailed in the response to the questions in Section 4.2.

Yours

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Appendix 1

Detailed answers to your questions

1.14 – The FRC would welcome views on the policy objectives against which to judge a Stewardship Code.

We support the policy's overall objective to provide for institutional investors, a framework which encourages active communication and stewardship between them and the companies in which they invest. We also support the intention of enhancing the communication of stewardship policies to the ultimate beneficiaries of funds managed by institutional investors.

Some general observations about the Code are:

- We support the overall objective of the Code, as a means to formally recognise best practice for effective engagement between companies and shareholders.
- We support the objective of increasing the transparency of institutional investors when it comes to corporate responsibility.
- We support the voluntary nature of the Code and the "comply or explain" approach of the Code.
- We can see an argument for an independent review of compliance with the code, but feel that more work is required to weigh the costs and benefits. In addition, we note that the ISC Code principles require some amendment in order that such assurance can be provided.
- We support using the ISC Code as a starting point but note that it should be enhanced and improved in order to achieve the desired objectives of the Code
- We support public disclosure of policies but note that these public disclosures should clarify what needs to be disclosed and to whom.

1.16 – The FRC is seeking views on whether it should accept oversight of the Code in its current form, or whether amendments should be made before the FRC does so.

We support the FRC taking oversight of the Code but note that the Code, as drafted, needs to be amended to be effective specifically in relation to the principles and the ability to obtain assurance over them. See answers to subsequent questions below for specific comments.

1.17 – Views are also sought on which institutional investors and agents should be encouraged to apply the Code on a "comply or explain" basis, what they should be asked to disclose and to whom and the monitoring arrangements that should be in place.

We note that the Code should apply to all institutional investors who act in a fiduciary manner on behalf of clients and all parties in the investment chain should apply this. This would include retail fund managers, hedge fund managers, institutional investment fund managers, pension funds, investment companies, insurance companies and voting services.

We note that the Code should provide further guidance as to how each of the parties in the investment chain should be expected to apply the principles. Several entities that would be classified as "institutional investors" may be considered too remote from the detail of the investment process to take direct stewardship responsibilities over investee companies. For example, pension funds generally employ FSA registered investment managers and have little exposure to day-to-day investment activity. In other instances, the FSA registered investment manager might invest through a pooled investment vehicle. In its current form, it is not clear whether the "comply or explain" requirement within the Code applies to the pension fund, to the investment manager or the pooled investment vehicle manager.

Further details are provided in subsequent questions.

2.18 – The FRC would welcome any insights on lessons which may be learned from experience outside the UK

In the US, there are significant disclosure requirements for registered mutual funds. Their annual prospectuses require disclosure over the policies and procedures employed by an investment manager in relation to proxy voting and conflicts of interest. In addition, the manager must disclose, at least annually, how the manager voted on all proxy votes. We urge the FRC to seek insight into lessons learned by US institutional investors in view of the common issues experienced in the credit crisis.

3.6 – The FRC would encourage all UK institutional investors to apply and report on the Code regardless of whether or not they are subject to mandatory requirements, and would welcome views on whether there are any barriers or other reasons that would prevent or discourage them from doing so.

We consider the most significant barriers to applying the Code would be the ability to obtain independent assurance over compliance with the Code, a perception of additional costs that compliance might entail and, for some institutional investors, a limited desire to comply with its requirements.

Several of the principles in the ISC Code could potentially be verified under the ICAEW's AAF 02/07 framework. One of the key challenges of assurance verification is the existence of objectively verifiable criteria against which assurance can be given. An AAF style assurance report requires a more granular definition of criteria than is the case with the current requirement for auditors of listed companies to review compliance with the published Corporate Governance Statement.

We are unable to determine a cost to applying the Code. Please see comments noted in 5.14 regarding the cost of independent assurance.

Institutional investors often view their role in investing in listed companies as being to provide a positive return to the investors in their products. This may involve a passive approach to investment management and managers may not consider it their responsibility to take on a stewardship role.

3.9 – 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?

We note that, under 3.6 above, the FRC would encourage all parties involved in the investment chain to follow the Code. If institutional investors use these services, it should form part of their overall stewardship policy. The Code should require that, if an institutional investor claims compliance with the Code, then its agents should also comply with the Code. UK institutional investors could therefore make it a condition of engagement with any investment manager, voting agency or investment consultant that they would abide by the Code.

3.13 – The FRC is keen to hear from foreign institutional investors in response to this consultation.

We have no comment on this question.

3.14 – The FRC would also be interested to hear from investors who operate on a cross-border basis about any potential conflicts which might arise between requirements or codes in place in other countries and the proposed Stewardship Code.

We have no comment on this question.

4.2 – Respondents are welcome to comment on any aspect of the ISC Code, but in particular views are invited on these questions:

What are the responsibilities for engagement of institutional shareholders to the beneficial owners whose interest they represent? Does the ISC Code cover all the relevant responsibilities?

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?

We note that institutional shareholders have the responsibility to keep their clients' interests in mind when performing a stewardship role. Institutional investors may adopt an active or a passive role to the stewardship of investee companies. This choice is often dictated by the client and articulated in the terms and conditions of their agreement with the institutional investor. An institutional investor who takes an active role would have the responsibility to vote on all proxy votes and engage in dialogue with management to agree common objectives.

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

The length and complexity of the investment chain contributes to the perceived stewardship gap between investee companies and the eventual owners of listed companies. We note that the ISC Code, as currently written, is not sufficiently clear regarding the different parts of the investment chain. Different institutional investors invest in companies through a variety of means (e.g. directly, pooled investment vehicle, through a third party manager). The ISC Code should be amended to articulate the different roles (the "links") in the investment chain. The ISC Code should also define which entities in the chain would be required to "comply or explain" and provide further details as to how the Code applies to each of the "links" in the investment chain.

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 the appropriate degree of transparency?

We note that the Code should strike the right balance between over-specification and the need to have an appropriate degree of transparency. For example, the ISC Code notes the need for an enhanced quality of dialogue between institutional investors and investee companies in its introductory paragraphs. This need is not fully reflected in the content of the ISC Code itself, which appears to focus more upon the monitoring of investee companies and the disclosure of policies. The content of the ISC Code should clearly articulate principles and guidance for institutional investors regarding open dialogue, engagement and a shared understanding of objectives.

We note that there is a need to provide additional guidance or clarity in some of the principles in the ISC Code to enable independent verification to be achieved, as noted below.

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

We note that the principles and guidance set out in the ISC Code will need some amendment in order to enable verification of compliance with the Code. Such amendments will be required in order to provide objectively verifiable criteria which may be reported upon. In reviewing the principles and guidance in the ISC Code, we factored in the ability to obtain independent verification in order to comply and note the following:

Principle 1: Institutional investors should publicly disclose their policy on how they will discharge their stewardship responsibilities.

We note that this principle should be included in the Code and that it is objective and verifiable. This principle requires no amendment for it to be capable of independent verification.

Principle 2: Institutional investors should have a robust policy on managing conflicts of interest in relation to stewardship and this policy should be publicly disclosed.

We note that this principle should be included in the Code. However, further guidance is required concerning; what constitutes a conflict of interest, the expected objective of a policy on managing conflicts of interest and dealing with conflicts of interest between different client groups (eg where an investment manager has funds which are "short" of a security and also has funds which are "long" of the same security).

We note that this principle is only partially verifiable. Whilst it is possible to obtain verification that the policy is publicly disclosed, assessment of whether a policy is "robust" would not be possible as this is a subjective matter.

Principle 3: Institutional investors should monitor their investee companies

We note that this principle is the most important to the ISC Code. We note that this principle needs to be expanded upon in order to provide further information on what the ISC Code means by "monitoring". Guidance should be given on; what "monitoring" means, the level of monitoring that should be expected and how this should be documented.

We note that this principle is not independently verifiable as currently written as the requirement is subjective and insufficiently precise.

Principle 4: Institutional investors should establish clear guidelines on when and how they will escalate their activities as a method of protecting and enhancing shareholder value

We note that this principle should be included in the Code but needs to be amended to clarify what is meant by "clear guidelines" and "enhancing shareholder value".

We note that this principle is not verifiable as in its current form as it is subjective. We note that this principle could be amended so that it can be independently verified.

Principle 5: Institutional investors should be willing to act collectively with other investors where appropriate

We note that an investment manager could be acting on behalf of several different types of investors who may have different goals. This might inhibit a manager acting collectively with other investors. The guidance supporting this principle should be clarified to provide further direction on when acting collectively would be appropriate.

We note that this principle is not independently verifiable as currently written. It would not be possible to verify whether it is appropriate to act collectively with other shareholders. The guidance supporting this principle should be enhanced to help firms determine when it is appropriate to act collectively.

Principle 6: Institutional investors should have a clear policy on voting and on disclosure of voting activity.

We concur with this principle and would recommend that the guidance be developed to require institutional investors to document the policy and confirm compliance with this policy. The principle could be enhanced by including a requirement for the policy to be adhered to and compliance documented.

We note that this principle is not independently verifiable in its current form as it is subjective. We note that the guidance could be developed, e.g. it should not include a requirement that the policy be "clear" as this is subjective.

Principle 7: Institutional investors should report periodically on their stewardship and voting activities.

We note that this principle should be included in the Code and that institutional investors should disclose their voting record at least annually. We note that this principle is independently verifiable.

4.4 – A table comparing the ISC Code with Section E of the Combined Code is at Appendix C but the key differences are highlighted below. Views are invited on whether the ISC Code adequately covers the content of Section E of the Combined Code.

We note that the ISC Code adequately covers the content of Section E of the Combined Code.

5.2 – The FRC would welcome views on the information that institutional shareholders should make publicly available and that they should report to clients.

We agree that putting more information into the public domain will allow for a better understanding of stewardship. Public confirmation of compliance with the Code may be insufficient to address the concerns expressed in the Walker Report. Although the ISC Code requires public disclosure of voting records, disclosure appears to be focused primarily upon the policies adopted rather than compliance with those policies. We note that institutional investors should disclose to the public and report to clients as to how they have complied with the Code.

We note that compliance with the Code should be described through an annual "Stewardship Report" which would describe how the principles of the ISC Code have been complied with. The "Stewardship Report" should contain sufficient information to enable readers to evaluate how the principles have been applied, with an explanation of non-compliance against each of the principles where applicable. The minimum content of the "Stewardship Report" should be specified in the Code.

We note that institutional investors should explicitly state their expectations of stewardship over investee companies and agree this with their agents. If institutional investors do not state their expectation of stewardship by their agents then reporting by those agents could not be expected to be effective. Reporting by agents to their clients should, in addition to the publicly available "Stewardship Report", be focused upon describing how the expectations of the institutional shareholder have been met.

Disclosure and reporting should distinguish between that which has been independently verified and that which has not.

(5.2 continued) The FRC would welcome views on the arrangements that should be put in place to monitor how institutional shareholders apply and report against the Code;

We can see an argument for an independent review, but feel that more work is required to weigh the costs and benefits. Compliance with the Code by institutional investors could be verified by an independent assurance opinion under the AAF 02/07 (or equivalent international) framework. As noted above the investment chain may contain many links which separate the ultimate owners of companies from the detail of stewardship over those companies. Independent verification would provide valuable assurance over the information reported to clients concerning compliance with the stewardship policies adopted.

As noted above some of the current drafting in the ISC Code would make independent assurance difficult because the principles require subjective judgement. Areas of the ISC Code should be enhanced to enable objective assessment possible. Guidance should be developed as to which principles should be subject to independent verification and which areas lie outside the scope of such assurance.

(5.2 continued) The FRC would welcome views on the arrangements for reviewing the operation and content of the Code.

We concur with the continual assessment of the Code to update it on a periodic basis. We note it would be appropriate for the FRC to maintain the oversight of the operation of the Code across all institutional investors and that the current IMA survey could assist in achieving this responsibility. We note that the IMA should not be solely responsible for monitoring the overall application of the Code as it is an investment industry body and does not represent all institutional investors. We recommend that the FSA should monitor the application of the Code (for those entities which is regulates) and provide public reports upon general themes and specific reports to regulated entities concerning their compliance with the Code.

5.3 – The FRC would welcome views on two issues: 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.

We welcome the public disclosure option and note that the disclosure over stewardship responsibilities, conflicts of interest and voting records will be of great benefit to their clients.

We believe that the “comply or explain” approach has some merit but recommend that the FRC provide additional guidance over what is required in order to demonstrate compliance and what form of explanation would be required for non-compliance.

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

We believe that public disclosure will be beneficial but also that reporting to the clients of the institutional investor is the most important medium of communication. We recommend that the clients of the institutional investor (or its agents) should receive a greater level of detail than the public. For example, in respect of pension schemes disclosure to scheme members (as scheme beneficiaries) should be made in respect of the fund’s stewardship policies and how these have been complied with.

5.10 – Views are invited on the structure of the ISC Code and on the best way to encourage reporting against it on a “comply or explain” basis.

We note that the structure of the ISC Code is appropriate but needs to be amended, as discussed in 4.2 above. We do not have further comment on ways to encourage a “comply or explain” basis.

5.14 – Views are invited 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 the benefits to the asset owners.

We concur with the desire to obtain independent opinions over compliance but note that there are several areas of the ISC Code that are too subjective to allow for an independent opinion. The details of these concerns were discussed in 4.2 above.

Where an existing AAF report (or equivalent assurance report on controls) is issued by a firm who seeks to comply with the Code, we would anticipate that such a report could be extended to cover this. In such a circumstance, we would anticipate that there would be a small incremental cost to including assurance reporting on compliance with the Code. Where a firm does not already issue an AAF (or equivalent report), we would expect the incremental cost to be greater, although the actual amount may vary from firm to firm and would be determined on an individual basis.

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

See our response noted in 5.2 above.

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

We support the overall approach the Stewardship Code is taking. We support the “comply or explain” mechanism and the periodic review of the Code.

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