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Our reference: Stewardship code.doc

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By email: [stewardshipcode@frc.org.uk](mailto:stewardshipcode@frc.org.uk)

Dear Susannah;

**Re: Stewardship Code**

Thank you for the opportunity to submit comments in relation to the FRC's adoption of a Stewardship Code.

Manifest was formed in December 1995 to facilitate informed governance and share ownership through the provision of timely, relevant and consistent research; electronic proxy vote management and associated reporting activities.

The rationale behind our proposition was the Cadbury Committee's observation that: *"Voting rights can be regarded as an asset, and their use or otherwise of those rights by institutional shareholders is a subject of legitimate interest to those on whose behalf they invest. We recommend that institutional investors should disclose their policies on the use of voting rights"* (para 6.12).

We were also influenced by the work of a number of noted governance academics, Dr Geof Stapledon<sup>1</sup>, who in July 1995 was at the Law School of the University of Melbourne in Victoria, now Group Manager, Governance BHP Billiton, Australia, and later Helen Short and Kevin Keasy<sup>2</sup> both of, University of Leeds.

These academics noted the increasing emphasis on the need for investors to play an active role in the governance of companies. All noted problems existed in reconciling the role of investors as active and informed owners, stated public policy positions of investors as owners and the actual activity taking place either at the corporate ballot box or elsewhere.

The oft-quoted reason for the lack of participation in voting was the complexity of balancing the workload, undertaking detailed monitoring and efficient vote lodgement systems of similar construct to those used elsewhere in the investment process.

However, it soon emerged that in the majority of instances, there was no organisational commitment to the concept of governance or voting and that participation was seen as a marketing activity in order to secure certain types of mandates.

We do not intend to re-rehearse the many academic and political arguments surrounding the role of investors in the ownership process. If we accept that governance is here to stay, we would prefer to focus our energies on the practical outcomes of what has passed for ownership in the UK hitherto and address possible alternative frameworks.

The Walker Review highlighted concerns that the boards of BOFI's had become held captive to "Group Think". This is a well known psychological phenomenon<sup>3</sup> which applies to any group of individuals. It is the act or practice of reasoning or decision-making by a group, especially when characterized by uncritical acceptance or conformity to prevailing points of view. Group Think occurs when the pressure to conform within a group interferes with that group's analysis of a problem and causes poor group decision making. Individual creativity, uniqueness, and independent thinking are lost in the pursuit of group cohesiveness.

Have investors and their agents become hostages to Group Think in the governance context? We would argue strongly that, even with the best of intentions on behalf of all involved, this is very much the case.

Avoiding Group Think requires a new approach to problem solving, a willingness to challenge flawed procedures, recognition and management of excessive self interest and conflicts of interest. Above all, the group needs new leadership which can take on a statesman like approach to managing and balancing the divergent views of stakeholders, and guard against the bureaucratic inertia and political sabotage which inevitably arise.

Manifest therefore views the role of the Financial Reporting Council as pivotal in moving the governance debate forward, not just in the UK but on a wider global stage. The UK has earned a reputation for high standards of corporate governance and the "Comply or Explain model" of the UK Corporate Governance Code and its predecessors demonstrates the value of a broad stakeholder approach to developing regulatory frameworks.

It is likely that other European jurisdictions - the EU included - will take very seriously the conclusions of this review. There is therefore a certain responsibility to not duck the challenge of ensuring a truly transparent notion of stewardship which genuinely empowers the asset owners to be in control of the processes for which they ultimately bear the economic responsibility.

Very importantly, the FRC's involvement with the Stewardship Code, and possibly in the future as we outlined in our response to the Walker Review, a Stewardship Council, represents a fresh start. Not that the past is totally without its merits, simply that after almost two decades of much public hand-wringing about the role of shareholders we appear to be still debating the same issues. This may be deliberate - it avoids the need to actually do something but gives the impression of a great deal of activity.

We are conscious of the wider political and media agenda for the need to name, blame and shame. The danger of this is that there is a strong desire for participants to rush to introduce new regimes and structures.

Therefore we would like to say that, in the first instance, we unequivocally welcome the FRC's role as the Steward of Stewardship.

In the second instance, we do not welcome a wholesale adoption of the Institutional Shareholder Committee's Code as it currently stands. The revised ISC Code presented to the FRC was not made the subject of market-wide, comprehensive stakeholder input. Given that the share registers of UK plc are now largely populated by non UK investors it is important to consult as widely as possible so that these divergent views can be taken on board.

Taking your initial consultation document as our framework we would like to answer a number of the points raised:

<b>Para. 2.18</b>	<b>The FRC would welcome any insights on lessons which may be learned from experience outside the UK</b>
<p>In general, we would caution against the dangers of unintended consequences by using principles to define practice. Specifically, we strongly discourage making the implication that voting should be mandatory.</p> <p>Whilst we agree that a well-conceived and executed voting programme across an entire portfolio can and does enhance the intrinsic value of Stewardship in general, it should not be understood that voting <i>per se</i> is the cause. Voting is simply one tool, not the sole objective. The goal of the Stewardship Code with regard to voting should be to encourage investors to understand the relevance and importance of their voting rights, and to therefore take responsibility for them.</p> <p>One significant 'unintended consequences' example is that of the ERISA guidelines in the US which created the perception that applicable institutional investors must vote all their shares. The result was that investors all ensured that they were voting their shares, but without paying adequate attention to the quality of both the decision-making and operational voting processes they were using. The net result was a <i>de facto</i> disenfranchisement of asset owners (and often asset managers too) through deferring their decisions to unaccountable third party advisors without adequate oversight or monitoring that the decisions made do actually reflect the preferences of the asset owners at the individual level.</p> <p>The rush to voting created an economic environment to vote all the shares at the lowest possible cost to achieve a compliance tick in the box without appropriate safeguards regarding oversight.</p>	

3.9	<b>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.</b>
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We would welcome the promotion of transparent practice in the proxy advisory and proxy voting industries. This would promote more robust assessment of the quality of vote decision-making and voting processes; something which is critical for the achievement of ‘improved communication between shareholders and the boards of the companies in which they invest’ and ‘secur[ing] sufficient disclosure to enable institutional shareholders’ prospective clients to assess how those managers are acting’.

Manifest’s Comply or Explain model is built on two pillars:

1. Contractual obligation to our customers in terms of quality, clear lines of responsibility and accountability for services rendered;
2. Adherence to and respect for the CFA’s analyst objectivity and independence framework which is the backbone of the investment research profession.

Further “ghettoising” the governance community with its own special code of conduct would reinforce the perceived separateness of corporate governance from the investment process and defeat the object of the exercise which is to ensure that voting decisions are based on the best possible practices and integrated with the portfolio management process.

Manifest would also welcome a review of fund manager procurement procedures to better understand how the industry makes its buying decisions in the governance space. While it is now the rule for public funds to undertake regular market testing of goods and services to ensure “fitness for purpose”, it is very much the exception for fund managers.

4.2	<b>What are the responsibilities for engagement of institutional shareholders to the beneficial owners whose interests they represent? Does the ISC Code cover all the relevant responsibilities?</b>
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The ISC code is vague on the responsibilities for specific engagement of institutional shareholders to the beneficial owners whose interests they represent.

It could be made more explicit to include, for example, the right on the part of beneficial owners to access the reports that the institutional shareholders obtain from their agents as to the Stewardship activities undertaken. In addition, the Stewardship Policy of the institutional shareholder should be available to all beneficial owners, which of course would be the case if they are to be made publicly available.

However, if general opinion is that these Stewardship Policies should not be mandatorily publicly available, from a fiduciary perspective it would not be acceptable for such reports or policies to not be available to beneficial owners. The Policy should

include explanations as to how the institutional shareholder sees each provision it contains as relevant to investment return.

An additional aspect to the relationship between beneficial owner and the institutional shareholder who acts on their behalf is that of the contractual service agreement. Contracts with short term performance horizons help perpetuate a short-term perspective on investment practice. This does not preclude the validity of investors whose strategy is deliberately short term, but it does place more emphasis on the importance of those who would view themselves as long term investors (such as most fund managers, pension funds and Sovereign Wealth funds, for instance) to ensure their mandates underpin this.

As a natural consequence of the contractual service agreement point above, long term investors should be encouraged to develop their own meaningful notion of their ownership responsibilities which should include adequate monitoring for reporting and evaluation

<b>4.2</b>	<b>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?</b>
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The guidance to principle 4 of the ISC includes a number of suggested points of escalation of engagement, but strangely makes no mention of the use of voting rights. The use of voting rights to register opposition to management on issues which, hitherto, have been a point of contention between the shareholder and management, should be explicitly included in the guidance. This would help to contextualise the importance and relevance of voting rights within a balanced Stewardship and Engagement programme.

<b>4.2</b>	<b>Are the respective responsibilities of the different parts of the investment chain sufficiently clear and appropriate?</b>
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To the extent that specific responsibilities are outlined in the Code, it really only pertains in detail to institutional shareholders and asset managers. Whilst there might be a technical inference that all agents of the process are included (“any agents appointed to act on their behalf”), there are specific aspects to the nature of the responsibilities borne by these agents which are worth making explicit, especially with regard to transparency.

Specifically, as outlined elsewhere, the decision-making process behind voting recommendations produced by a proxy voting advisory service should be sufficiently transparent to the institutional shareholder to be able to understand how the advice is arrived at, regardless of whether the advice is tailored to the user or is provided ‘off the shelf’ by the research provider.

Additionally, the role of custodian banks in dictating the method of execution of voting rights is inappropriate.

Manifest is a strong supporter of open and accountable standards which enable the consumer to select services that best meet their operating needs and wider mission objectives, not simply the one that is either forced on them or associated with the “right” tribe.

Investors should be free to choose the means by which their votes are instructed in order that they can satisfy themselves that their votes have been appropriately communicated, rather than have that means imposed on them by the custodian bank who doesn’t share the economic interest of the voting client. This could be addressed through custody mandates, but the importance of it is sadly often lost on asset owners.

Best execution of voting rights could also be addressed through existing regulatory frameworks operated by the FSA. It is ironic that the City spends significant sums on Transferring assets (buying/selling), be that through direct commissions, spreads etc; yet the corresponding investment in ongoing ownership is, without exaggeration, miniscule.

The role of investment consultants in ensuring quality, pertinent issue identification in the selection of both fund managers and custodian banks is clearly important. Whilst it may be considerably harder to extend the scope of the Stewardship Code to include investment consultants (seeing as they are not directly involved in the stewardship process), it may be possible to achieve the desired result by recommending that asset management mandates specifically make mention of stewardship and the manner in which it is addressed by the tenderer.

Clear descriptions of WHAT is done and HOW rather than simply a statement that something is done without further clarity would be a welcome addition to informed decision making by beneficial owners.

**4.2**

**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?**

On balance the Code would seem to be too light on detail to deliver the transparency sufficient to be able to make it effective and to be able to effectively monitor it.

We recommend that some specific measures be chosen to ensure meaningful transparency. Some suggestions are included elsewhere in this response (below).

**4.2**

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

Principle 1: Need more specificity on what information investors should give about how they make use of proxy advice; stats on how often they follow the voting advice they receive, how that advice is arrived at, how they evaluate that advice and whether they have a bespoke voting policy in place.

Principle 7: Could include suggested guidance on the types of reporting on votes cast, such as detailing votes cast differently to management recommendations, cast differently to the client voting policy, cast differently to the agent's voting decision (where the mandate is a segregated voting mandate). It should also contain a complete explanation of the entire operational voting methodology in place, so that the underlying client can reasonably understand the 'best execution' aspect of their voting rights.

<b>5.14</b>	<b>Views are invited on the proposals in 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.</b>
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Whilst independent verification of information is useful for ensuring its accuracy, it has little effect on the usefulness of the information. To this extent, independent opinions from professional auditors are only as useful as the information they verify.

Attention should therefore be primarily focussed upon the quality and relevance of the information agents give to their clients as to the stewardship processes they have in place. The greater the quality of information, the greater the value and benefit of commissioning opinions.

We are however not sure why a new or special certification should be required for governance policies or procedures. Service organisations in the financial arena are frequently measured against AAF 01/06, successor to FRAG21/94.

<b>5.21</b>	<b>Views are invited on the merits of the current IMA survey and other possible approaches to monitoring the overall application of the Code.</b>
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There are currently two notable surveys of investor behaviour: IMA and TUC. Each has their individual merits, each has their own institutional objectives.

The FRC runs a significant risk of undermining the validity of the Code if its own participants were also responsible for monitoring its effectiveness and application, especially given the high profile of the issues which have brought about the need for a Stewardship Code in the first place.

In order to be consistent with the Combined Code, where monitoring is undertaken by independent, non-conflicted assessors engaged for the purpose by the FRC, we would like to see the FRC as an impartial authority engaging independent assessors to establish the effectiveness of the Stewardship Code. An appropriate RFP process is likely to attract a number of suitable applicants, including those from the academic community which would help underpin the objectivity of the process.

Thank you again for this opportunity to contribute to the FRC's deliberations. We look forward to a healthy and robust debate around these issues and wish you every success in your deliberations.

Yours sincerely



Sarah Wilson  
**Chief Executive Officer**

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<sup>1</sup> G. P. Stapledon, "Exercise of Voting Rights by Institutional Shareholders in the UK", Corporate Governance, Volume 3, Number 3, pages 144-155, 1995

<sup>2</sup> Institutional Shareholders and Corporate Governance in the United Kingdom, Corporate Governance, Economic Management and Financial Issues, chapter 2 pages 18-54, 1997

<sup>3</sup> Janis, I. Groupthink: Psychological Studies of Policy Decisions and Fiascoes. Houghton Mifflin, 1983.