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To: Stewardship Code
Subject: FRC - Stewardship Code

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Dear Ms Hahn

Consultation on a Stewardship Code for Institutional Investors

I am writing to set out my comments on the consultation paper on a Stewardship Code issued in January 2010. Although I am the chairman of a FTSE 250 commercial company and the chairman of a substantial FTSE 250 investment trust, I am writing in a personal capacity.

I found this a difficult paper on which to comment since it deals both with the general principles of stewardship as well as the details of a Code that was not prepared by the FRC. However, I attempt to provide some observations, for the most part using the paragraphs and questions of your paper.

Before going into the detail, perhaps I might first comment from a perspective of both a UK investor and a UK corporate. I am supportive of moves to improve the arrangements for stewardship. My concern is whether the FRC, in taking up Sir David Walker's recommendations, is trying to move the whole industry too fast. The issue of agent and principle has been around for a hundred years or more and seeking to implement comprehensive new arrangements in one fell swoop (from loosely applied ISC guidelines only two years ago to the full rigours of a fully developed Code), without detailed testing of the procedures, may lead to unnecessary disfunctional or bureaucratic behaviours.

The world does not naturally split into Stewards and Non-stewards; there are many different business models within the investment community that should be respected.

My suggestion is that the FRC might introduce the Stewardship Code in stages. First, as Guidance rather than a Code, for the first period of three years during which the arrangements proposed by the draft Code would be adopted by the UK's major investment institutions. My assessment is that a relatively small number of UK investment institutions hold a relatively significant proportion of the share capital of UK corporates and are the obvious Stewards, so the first step might be for them to trial the new arrangements on "voluntary" basis. Other firms should be encouraged to follow as much of the Code as fits their business model.

At the end of three years, the proposed assessment could take place, any necessary changes be made to the guidelines so as to convert them into a Code, and for the scope of the requirements to be rolled out more fully, and as appropriate, through the plethora of investment firms, intermediaries and agents each of whose holdings or role is probably not material to the stewardship of UK corporates.

As I describe below, the definition of the organisations covered by the proposed Stewardship Code is awkward and the ISC may have recognised this in allowing organisations to select whether or not they adopted the ISC Code.

There is good material within the FRC's recommendations but I think it could be a matter for regret if the new Code was introduced across the whole of the sector without testing. A staged process would also allow more thought to be given to the ways in which the Code would be monitored and assurances as to compliance provided.

Whether or not the Code is introduced on a staged basis, I would observe that the proposed requirements for reporting and monitoring appear excessively bureaucratic and I would suggest that they are not introduced

until the first triennial review at which stage there will be a better understanding of precisely who requires what reassurance. This does not seem to me the sort of code that needs active policing unless and until it is clear that it is not being adopted in the spirit that is intended.

I now move to the more detailed comments based on the assumption that the Code is indeed introduced as presently envisaged.

1.14, 1.16 and 1.17 - Scope

I found it difficult to obtain a clear understanding as to which organisations should be covered by the Code and those who would benefit from the Code.

Taking the example of investment trusts, whilst they may be authorised investment trusts for tax purposes, they are not authorised investment firms falling under the supervision of the FSA and therefore might be excluded from the Code. An investment trust might well have UK investors, but not be invested in any UK corporate. On the one hand, as a matter of public policy, it might be in the interest of investors for the Stewardship Code to be adopted by the trust although on the other, because it is not invested in UK corporates, it does not have a role in UK corporate governance. There are no doubt other such situations where greater clarification is required.

In paragraph 1.18 the word "agents" is used but without any definition.

Whilst the broad objectives of the Stewardship Code are understood, and come through the consultation paper, more detailed guidance as to coverage will hopefully emerge from the consultation process.

It would seem appropriate that the FRC should not accept oversight of the Code in its current form but should consult on the contents of the Code and issue a further consultation paper on the revisions prior to accepting its oversight role.

The ISC Code is in essence a voluntary code. Those who do not adopt it, and state reasons why, are relieved from further responsibilities. I assume that large numbers of institutional investors who more actively trade portfolios, and typically have relatively small individual interests in UK corporates, will decide not to apply the code. The Code would not be relevant to Trackers.

As stated above, in its initial phase, the ISC Code may be adopted by more active investors (probably the larger UK institutional investors) and it would seem to me preferable that the FRC, rather than issuing a code, should for the foreseeable future issue guidelines. This more holistic approach to stewardship represents a major change in the external responsibilities of investors and it may be preferable to determine in the initial stages how a new policy settles down around some guidance rather than within a code supervised on a "comply or explain" basis.

2.18, 3.6 and 3.13- Overseas experience

I have no comment

3.9 - Agents

One advantage of the Code being adopted initially as guidelines by the largest UK institutional investors would be that they clearly themselves accept responsibility for the governance of corporates. Whilst of course taking input from voting services agencies and investment consultants in order to inform them as to how they might vote, the voting itself should be undertaken knowingly by the individual institutional investor by reference to all the information that it has available. It should not be considered acceptable for an investor unquestioningly to follow the guidance of a voting agency. This will require a significantly closer link between the investment manager and the governance team within the institutional investor firm so that the particular circumstances of an individual corporate are better understood before voting takes place.

4 - Content of the code

Please see later comment in this note.

5.2 - Reporting

In principle, the extent of information reported should follow the requirements of the user. In the context of a private organisation, for example a pension fund, the reporting should be to the client concerned. In the case of a more general purpose investment fund, with multiple investors, reporting will probably be through the annual report and accounts. In its early stages, if the concept of guidance rather than a code is adopted, a general statement of policies would be appropriate. The thrust of stewardship is that there should be engagement between the investor and the company concerned and therefore specific reporting as to how votes have been exercised in individual cases would go beyond those principles.

It would seem appropriate that institutional investors adopting the guidance should publicly disclose, in general rather than in specific terms, their voting records. But it needs to be recognised that this is only to start a chain of explanations; arguably users of these reports would be interested in knowing whether having, say, voted against resolutions, the corporates concerned have amended their behaviour. The issue to me is not the detail, rather the fact that an investor has a policy that it has explained and states that it follows.

At this stage, I can see no benefit for investors or the FRC in seeking independent opinions from auditors or other professionals to confirm that the policy has been adopted adequately. It maybe that in some years time, once the guidance transforms into a code, that it becomes a matter of public interest that that it should be done. That time has not yet arrived.

I have no particular views on who might undertake the monitoring of the guidance/code. A review every three years would seem to be appropriate.

Content of the IFC Code

Principle 1. This appears unobjectionable. It will allow an interested party to determine whether an institutional investor is an active investor and engages with its investee corporates, or otherwise.

Principle 2 - no comment.

Principle 3 - no comment as regards the guidance, but the onus on the institutional investor to endeavour to identify problems at an early stage to minimise loss of shareholder value will separate those who are more active long-term investors from those who are, loosely, traders or trackers.

Principle 4 - I was happy with the word "establish" in the principle but felt that the words "set out" in the first line of guidance text might be particularly onerous and rigid. What is required here by institutional investors that adopt the guidance/code is that they should engage with the company. I am concerned that in the first bullet point it appears that this contact is with management. I would prefer that this was stated to be the Board and that the first port of call would be the chief executive (or his/her nominee) followed by the chairman or senior independent director rather than the company's advisers. In all cases, before an institutional investor votes against a resolution or abstains on it, there must have been a dialogue with the company concerned initially through the chief executive but subsequently the chairman or the senior independent director.

Principle 5 - whilst institutional investors should have the right to act collectively, the issues concerning insider status are complex. Rather than disclosing their policy (which I think would be difficult) the annual report summarising engagement policies might simply disclose on an anonymous basis the number of cases in which there has been collective engagement with another investor.

Principle 6 - I would repeat the requirement that if votes are registered against a resolution, or an abstention takes place, there should have been active dialogue between the investor and the company concerned before the proxies are lodged.

Principle 7 - no comment.

If there is any further information I can provide, please let me know.

Yours sincerely,

Peter Smith

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