



1 Commodity Quay - East Smithfield  
London E1W 1AZ

Ms Susannah Haan  
Financial Reporting Council  
Fifth Floor  
Aldwych House  
71-91 Aldwych  
London WC2B 4HN

Via e-mail: [stewardshipcode@frc.org.uk](mailto:stewardshipcode@frc.org.uk)

London, 10 April 2010

Dear Susannah,

**Subject: Response from RiskMetrics Group to the Financial Reporting Council Consultation on a Stewardship Code for Institutional Investors**

RiskMetrics is a leading provider of risk management and corporate governance services to the global financial community. By bringing transparency, expertise and access to the financial markets, RiskMetrics Group helps investors better understand and manage the risks inherent in their financial portfolios. We work to make risk transparent and leverage our expertise in corporate governance, compliance, accounting, legal, transactional, and sustainability risks. Our clients include over 2,000 fund managers, pension funds, banks and hedge funds.

We welcome the opportunity to respond to the Consultation on a Stewardship Code for Institutional Investors issued by the Financial Reporting Council in January 2010. Our response first outlines a number of general remarks regarding the merit of introducing a Stewardship Code under the supervision of the FRC. It then offers several detailed comments regarding the various sections of the Consultation.

## General remarks and comments to Section 1 of the Consultation

As a strong proponent of transparency in the market place, RiskMetrics fully supports the introduction of a Stewardship Code. As an overriding principle, we have always supported transparency in the execution of investors' duties, as well as in the running of companies. We believe that improving transparency, as well as advancing the long-term interests of companies and their shareholders, promotes confidence in the financial markets, thus ultimately creating stronger and more efficient markets.

Findings of a recent Study<sup>1</sup> released by the European Commission indicate that many shareholders do not appear to actively fulfil their fiduciary responsibility as owners in investee companies. Rather, many rely on other investors to provide effective monitoring by engaging and communicating with companies. This passive behaviour creates a well-known free-rider problem, which constitutes a severe market failure from a macro-economic point of view.

In the Study to the European Commission, RiskMetrics suggests that the issue could be best remedied by imposing disclosure standards on how institutional investors address their fiduciary responsibility as owners of companies<sup>2</sup>. Experience in other markets shows that disclosure requirements imposed on institutional investors encourages them to become more active in monitoring investee companies through dialogue and voting<sup>3</sup>. In short, transparency drives behaviour. Moreover, a soft regulatory approach under the "comply or explain" regime is more likely to lead to a purposeful dialogue between companies and shareholders, and should avoid the mechanistic approach that regulatory-enforced compliance can engender.

Consequently, RiskMetrics welcomes that the FRC accepts oversight of the Code and broadly supports the content of the Code in its current form. In order to ensure proper accountability of the Code at all levels of the investment chain (beneficial owners and fund managers among others), we encourage that the Code should require all institutional investors to apply it. Given that within this framework the Code would apply to a wide range of constituents, we suggest it should contain a limited number of overarching Principles and guidance to be applied by all institutional investors. The Principles could be further augmented with interpretative guidance published for specific constituents<sup>4</sup>.

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<sup>1</sup> Please refer to the *Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States*, pp.153 and following, at [http://ec.europa.eu/internal\\_market/company/docs/ecgforum/studies/comply-or-explain-090923\\_en.pdf](http://ec.europa.eu/internal_market/company/docs/ecgforum/studies/comply-or-explain-090923_en.pdf).

<sup>2</sup> See the *Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States*, pp.185-188.

<sup>3</sup> Please refer to the comments on Section 2 below.

<sup>4</sup> Such as the *Practical Guide (Pension Funds and the ISC Code)* issued by the National Association of Pension Funds.

Institutional investors will be required to follow the principles of the Stewardship Code on a “comply or explain” basis. However, there will be no direct enforcement mechanism equivalent to the shareholder vote against companies under the Combined Code. Hence, RiskMetrics is of the opinion that the effectiveness of the “comply or explain” regime applied to the Stewardship Code will mainly depend on (i) the degree of transparency required, (ii) the reliability of information disclosed by institutional investors, and (iii) its effective regulatory oversight.

First, the degree to which institutional investors would be encouraged to adhere to the best stewardship practices will depend on the type, quantity, and quality of information that the investors will be expected to disclose. In this respect, RiskMetrics formulates some high level suggestions in the answer to Section 4 of the consultation (see below).

Second, the reliability of the information reported on voting and engagement will be enhanced if those investors that sign up to the Code seek to obtain an independent audit opinion on their engagement and voting processes<sup>5</sup>.

Finally, oversight of the ISC Code by the FRC will form an appropriate independent monitoring mechanism which will foster a higher degree of transparency on its application by institutional investors, than they, or their trade bodies have achieved by themselves so far. The FRC’s oversight of the Code will elevate a pure self-regulatory approach by market participants and their respective trade bodies into a more effective soft regulatory approach, under the scrutiny of the FRC and the wider public.

## **Comments to Section 2 of the Consultation**

As highlighted in the Study for the European Commission, standards of investor disclosure concerning the fulfilment of their fiduciary responsibility as owners were introduced in France, the Netherlands and Portugal<sup>6</sup>. Experience in these countries points towards the positive effect of such standards on investor monitoring activity.

In Portugal, the regulator introduced a standard template by which voting records are disclosed. The introduction of such a template may facilitate reporting under the UK Stewardship Code.

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<sup>5</sup> Standards in AAF 01/063 (assurance reports on internal controls of service organizations made available to third parties) and SAS 70 (Statement on Auditing Standards n° 70: Reports on the processing of transactions by service organizations).

<sup>6</sup> See the *Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States*, pp.47-50.

### **Comments to Section 3 of the Consultation**

In its capacity of a provider of proxy and governance services, RiskMetrics fully commits to the spirit of the proposed Code.

RiskMetrics has always been fully transparent in relation to its voting policies, on a global and individual market level, to our clients, issuers, and the market at large<sup>7</sup>. We are also completely transparent with our clients with regard to our engagement activities. Our engagement with UK companies is pro-active. For example every year we initiate contact with all FTSE All-Share companies in advance of the reporting season, to fully brief them on our remuneration and governance policies, and to facilitate timely and meaningful engagement on our clients' behalf. Any adverse voting recommendation is only made after in-depth discussion with the affected company. A pre-publication draft is also sent to the company<sup>8</sup>.

RiskMetrics is also willing and equipped to support its UK institutional investor clients disclose "the use made of (...) proxy voting or other voting advisory services, including information on how they are used", as articulated in Principle 1 of the ISC Code.

We believe that, investment consultants should be similarly encouraged to commit to the spirit of the Code, notably by committing to systematically analyse and compare the level and quality of the monitoring activities (in the form of voting and engagement) offered by fund managers.

Foreign investors should be encouraged to commit to the Stewardship Code on a voluntary basis. In fact, anecdotal evidence collected recently by RiskMetrics indicates that some foreign investors are already gearing up to apply the content of the Stewardship Code on a voluntary basis, among others to respond to expected demand from underlying UK-based end-investors. Similarly, RiskMetrics believes that all investment activities conducted by UK-based institutional investors should be subject to the principles of the Stewardship Code, including funds effectively managed from the UK but domiciled elsewhere (such as Luxembourg- or Ireland-domiciled mutual funds managed by UK-based fund managers).

### **Comments to Section 4 of the Consultation**

As explained in the introductory comments, RiskMetrics believes that the current content of the ISC Code broadly covers all the relevant responsibilities effectively whilst avoiding over-prescription.

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<sup>7</sup> See RiskMetrics' 2009 voting policies at: [http://www.riskmetrics.com/policy/2009/policy\\_information](http://www.riskmetrics.com/policy/2009/policy_information).

<sup>8</sup> See RiskMetrics' engagement policy at: <http://www.riskmetrics.com/policy/EngagingWithISS>.

However, further clarification might be needed regarding the scope of engagement activity. Indeed, the consultation document refers to institutional shareholders' responsibility to engage only with those investee companies that are based in the UK. This principle seems to be in slight contradiction with Principle 6 of the ISC Code which calls for institutional investors to vote all shares held (including non-UK shares). RiskMetrics believes that investors' responsibilities should extend to all investee companies, as the exercise of monitoring investee companies should not be geographically bound.

### **Comments to Section 5 of the Consultation**

As explained in our introductory remarks, RiskMetrics believes that transparency will be the key to the successful implementation and success of the Code. Full and quality disclosure is the only market mechanism by which beneficial owners will be able to monitor and compare how their agents have satisfied their fiduciary responsibility to monitor investee companies. The suggested "comply or explain" approach applied to institutional investors does not foresee a voting sanction akin to that applied to companies in the framework of the Combined Code.

Hence transparency and public disclosure will be paramount in:

- i) driving behaviour, in the spirit of the Code, rather than compliance;
- ii) allowing comparability, which is important for beneficial owners in awarding and renewing investment mandates; and
- iii) permitting owners to fully understand the governance commitment of institutional investors.

Institutional investors should be expected to disclose quality information on how they have discharged their fiduciary responsibility with respect to all six Principles of the ISC Code.

In order to foster a level playing field among institutional investors and allow for easy comparison of their engagement activities, we would suggest that a standard reporting template be developed by market participants, under the supervision of the ISC and be subsequently validated and enforced by the Financial Reporting Council and the Financial Services Authority. The wide adoption of a reporting template would also facilitate the monitoring of the Code by the FRC.

Such a template would need to strike a balance between quantity and quality. It should be sufficiently specific and illustrative to allow for a proper assessment of:

- i) the stewardship policies;
- ii) the universe of portfolios and companies to which the policies apply;

- iii) the ways in which policies are implemented in practice, including quantitative information (in the form of statistics, such as the percentage or number of resolutions voted against management, the percentage or number of shareholder resolutions supported, the percentage or number of activities being escalated, etc.) as well as qualitative information (such as examples of issues voted against management, examples of managing conflicts of interest, examples of escalation, etc.);
- iv) the resources, both internal as well as external, devoted to their stewardship and voting activities;
- v) the outcomes of their stewardship activities, so that they can be checked periodically for their effectiveness.

In light of the objectives highlighted above, in terms of transparency requirements, we would suggest that all summary information be made available to the wider public, while detailed information (such as individual voting records or records of private meetings held with companies) be made available by each institutional investor to its beneficial owners upon request. In addition, institutional investors could elect to make all detailed information publicly available on a voluntary basis.

Finally, RiskMetrics would welcome a review process to be undertaken periodically. The process could involve public consultation with those applying the Code and other interested parties. The substance of the review could include the content of the Code, its overall effectiveness, its reporting requirements, and the “comply or explain” mechanism.

We trust that you will find the above comments and suggestions useful in the context of the FRC Consultation on a Stewardship Code for Institutional Investors. We remain at your disposal if you would like to discuss anything in further detail.

Yours sincerely,

A handwritten signature in blue ink, appearing to read 'Jean-Nicolas Caprasse', with a horizontal line extending to the left.

Jean-Nicolas Caprasse

European Governance Head