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Dear Chris

### **REVISIONS TO THE UK STEWARDSHIP CODE - CONSULTATION**

IMA represents the asset management industry operating in the UK. Our members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of £4 trillion of assets, which are invested on behalf of clients globally. These include authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles. In particular, the Annual IMA Asset Management Survey shows that IMA members managed holdings amounting to just over 40% of the domestic equity market.

In managing assets for both retail and institutional investors, IMA members are major investors in companies whose securities are traded on regulated markets. Therefore, we have an interest in the Stewardship Code from the perspective of our members as institutional investors in companies. The FRC first issued the Code in July 2010. Two years later it is appropriate for it to be reviewed and we welcome the FRC not proposing to change it fundamentally in that it should be given time to settle down. As regards the two tests, in general we welcome:

- the additional clarification proposed to the introductory sections - this will help signatories understand better certain terminology and help encourage greater transparency in any policy statements; and
- certain amendments to the guidance in that they achieve a balance in clarifying the text whilst avoiding any temptation to add unnecessary detail.

We also support the changes or additions relating to:

- other asset classes, the FSA disclosure requirement on adherence to the Code, and the role of service providers in the introductory sections;
- disclosure of the approach to stock lending and recalling lent stock in the guidance to Principle 6; and
- revisions to Principle 3 on what monitoring entails and insider dealing, and the fine tuning of Principle 4.

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However, there are other areas where we have concerns. We set out our key concerns below and in the attached Annex our more detailed observations.

- **Application overseas.** The introductory section discusses the application of the Code to overseas holdings. Certain of our members consider this should be deleted on the basis it would be impractical if every country expected its own Code to be applied, not only in its own country, but by its home institutional investors to their overseas holdings. This could result in investors having to apply a number of Codes to particular holdings. Others do not have such strong concerns but where separate Codes exist would like to see mutual recognition.
- **"Comply or explain" or "comply or else".** The Stewardship Code is to be applied on a "comply or explain" basis but in many instances the proposed changes strengthen the text. We are concerned this may impact those signatories that "explain" in that non-adherence, even if accompanied by a valid explanation, may be viewed more negatively. This is particularly relevant to Principles 6 and 7 on the public disclosure of voting records and the independent verification of stewardship. The value of public disclosure and independent assurance needs to be proportionate to the needs of users. We set out our detailed concerns on pages 6 and 7 of the Annex and recommend that Principles 6 and 7 revert to the original text in this regard.
- **Disclosures.** Whilst in the original Code the majority of disclosures were in the guidance to Principle 1, this was not consistent. For example, the requirement to disclose the policy on collective engagement was in Principle 4 and on voting disclosure in Principle 6. It is now proposed that the requirement to disclose the "strategy on intervention" is removed from Principle 1 in that Principle 4 requires investors to "set out circumstances when they will actively intervene". Also under Principle 3, investors are now expected to disclose their willingness to be made insiders.

We consider it would be simpler if all disclosures were aggregated in an appendix/checklist. First, it would make it easier for signatories to draft their policy statements. Secondly, under the stewardship supplement to the AAF 01/06, Assurance Reports on Internal Controls of Service Organisations Made Available to Third Parties, assurance reporting focuses on the description of policies and processes relating to Principles 1, 2, 6 and 7 on the basis the other Principles are not 'objectively verifiable'. For the Code to require disclosures under certain other Principles confuses this, and which Principles can be objectively verified and are subject to this assurance. A separate Appendix/checklist would resolve this whilst retaining the cohesiveness of the separate Principles.

We trust that the comments above are self-explanatory, but please contact me if you would like clarification on any of the points in this letter or if you would like to discuss any issues further.

Yours sincerely



Liz Murrall  
Director, Corporate Governance and Reporting

## IMA's DETAILED COMMENTS

### Introductory sections

#### The definition of stewardship

*The FRC is aware that there is some confusion in the UK market and overseas as to what "stewardship" means. For example, there is a perception in some quarters that the Stewardship Code is solely concerned with socially responsible investment. The proposed revisions in the introductory sections and in the guidance to Principle 1 are intended to clarify what is meant by stewardship, its purpose and how it relates to governance.*

#### **Views are invited on whether the proposed revisions correctly describe stewardship and its purpose.**

IMA welcomes the change and agrees that the revised text provides a clear definition of stewardship and its purpose, and makes it clear that it is not limited to socially responsible investment. However, in the guidance to Principle 1 corporate governance should come before remuneration in the second line of the guidance which should state: "such as strategy, performance, risk and corporate governance including remuneration".

#### The roles of asset owners and asset managers

*The FRC noted in its 2011 report confusion about the responsibilities of asset owners and asset managers. The proposed revisions in the introductory sections and Code are intended to identify more clearly the different responsibilities of asset owners and asset managers. The revisions also include an explicit recognition that asset owners have a stewardship obligation to their beneficiaries, while recognising that the specific stewardship activities of owners and managers will vary depending on their circumstances.*

#### **Views are invited on whether the respective responsibilities of asset owners and asset managers have been correctly described.**

IMA considers the descriptions of the respective responsibilities of asset owners and managers are clear and notes that where the distinction is not, the institutional investor itself should determine what is appropriate. On a minor point, we question the use of the term "spirit" in paragraph 7 on page 4 on the application of the Code: "*asset owners' adherence to the spirit of the Code may include.....*" This seems to draw a distinction between asset owners only adhering to the "spirit", and the clearer expectations of asset managers. The text "the spirit of" should be deleted.

Moreover, the original preface to the Code stated that: "institutional shareholders are free to choose whether or not to engage but their choice should be a considered one based on their investment approach". This is not included in the current draft. As a result the Code no longer recognises that in acting as fiduciaries on behalf of clients, asset managers offer a choice and take a range of approaches to managing money. Some believe that actively engaging with investee companies will achieve better returns. Others believe the best way to send a signal to a badly managed company and maximise returns for clients is to sell their holding. Nor does it recognise the limitations in terms of what engagement may achieve. Thus whilst investors may be well positioned to advocate for change, they may not necessarily have sufficient influence to effect that change. It cannot be assumed that a board's failure to respond to investor engagement is an indication that investors failed in to engage in a meaningful way.

#### Application overseas.

*Paragraph 10 on page 4 notes that overseas investors that disclose under other codes that have similar objectives can be used to demonstrate compliance with the Code. It goes on to state that UK institutions that apply the Code should use their best endeavours to apply its principles to overseas holdings.*

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Certain of our members consider this text on the application of the Code to overseas holdings should be deleted. They consider it would be impractical if every country expected its own Code to be applied, not only in its own country but by its home institutional investors to their overseas holdings. This could result in investors having to apply a number of Codes to certain holdings. In particular, it would be confusing and onerous if each code had its own disclosure and reporting requirements. There are also concerns that the different regulatory and legal frameworks internationally may impact engagement and the information investors are permitted to disclose. For example, differing "acting in concert" rules could give rise to concerns over collaborative engagement under Principle 5 in certain markets. Others do not share the extent of these concerns but where separate Codes exist would like to see mutual recognition.

### Relevance of signatories' statements

*The FRC notes that only a small fraction of institutions that became signatories in 2010 had updated their policies in 2011. So as to encourage signatories to have statements that reflect their current practice, a proposed addition to the introductory section to the Code requests that signatories review their policy statements annually, update them as necessary, and indicate the date of their last review.*

Whilst the FRC noted that only few changes were made to policy statements in the first year, we suggest that policies may have been reviewed but few, if any, changes made. We propose amending IMA's questionnaire from which we gather data in order to prepare our report on Adherence to the Stewardship Code to solicit this information and welcome this proposed change to the Code.

### Principle 2

#### Conflict of interest policies

*The FRC noted that the reporting in signatories' statements of how conflicts of interest were managed was frequently weak, noting that few signatories stated they always sought to place the interest of their clients first. The proposed revisions to Principle 2 aim to encourage more informative disclosure, while recognising that the interests of clients may vary, and is intended to be consistent with the Financial Services Authority's requirements. In addition, robust" is replaced with "effective" as signatories expressed concerns that it was difficult to demonstrate "robustness".*

IMA agrees that the changes to the Principle and guidance will encourage fuller disclosure by signatories. However, we are concerned about the term "effective" and the implications for this being objectively verified under the guidance in the stewardship supplement to the AAF 01/06, Assurance Reports on Internal Controls of Service Organisations Made Available to Third Parties<sup>1</sup>, or that signatories would want their reporting accountants to undertake such detailed and, what could be, costly work.

We consider a better term would be for a conflicts of interest policy to be "suitable" and one that could be followed in a variety of circumstances.

### Principle 3

#### Insider information, acquisitions and sub-underwriting

*The FRC recognises that the current language in the guidance to Principle 3 of the Code could be interpreted as a suggestion that institutional investors should not become insiders. It has therefore proposed revisions that remove any such inference by stating that "institutional investors may or may not wish to be made insiders", and requesting that institutional investors who may be willing to*

<sup>1</sup> <http://www.icaew.com/en/technical/audit-and-assurance/assurance/technical-release-aaf-01-06>

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*become insiders indicate as much in their stewardship statement. As well as adding bullets to better align Principles 3 and 4, it is proposed that investors: "consider the quality of the company's reporting".*

IMA welcomes changes that remove the inference that investors should not become insiders and add that they should consider the quality of a company's reporting. This latter point is particularly important given the recent concerns of the Professional Oversight Board regarding auditor scepticism. We also consider that there would be benefits with more and better engagement between investors and audit committees. We would welcome the FRC highlighting this revision and its potential benefits when the revised Code is published.

It would also be helpful if the Code recognised in Principle 3 that the depth and breadth of monitoring and engagement may differ based on an investor's investment strategy or style, for example, active quant/active fundamental/passive.

### Principle 4

*It is proposed that the phrase "as a method of protecting and enhancing value" is removed from the Principle in that it is now in the introduction to the list of Principles.*

IMA supports this change. However, we consider the sentence: "instances when institutional investors may want to intervene include when they have concerns about the company's strategy, and performance, its governance, remuneration or its approach to the risks, including those that may arise arising from social and environmental matters", should offer more flexibility in setting out matters for engagement. A means of addressing this would be to substitute "include" with "include but are not limited to".

### Principle 5

#### Collective engagement

*A number of statements by Code signatories on collective engagement focus only on membership of collective bodies. The proposed revisions to the guidance to Principle 5 therefore emphasise that what is sought is not just information about membership of investor organisations but also an indication of the sorts of circumstances in which the investor might participate in collective engagement.*

IMA agrees that proposed text clarifies that it is expected that investors indicate the circumstances when they might participate in collective engagement. However, whilst the introductory sections make clear the "comply or explain" approach to the Code, the proposed text states collective engagement may be: "necessary to achieve their objectives and ensure companies are aware of concerns". Collective engagement may not always be appropriate and can give rise to concerns particularly in relation to the change of control regime under the FSA's rules. We consider it would be preferable if this was qualified in some way, for example, to state: "...disclose their policy on their readiness to work with other investors through formal and informal groups. *At times this may be an effective method* to achieve their objectives and ensure companies are aware of concerns".

Furthermore, we have concerns with the assumptions underlying the revised text as articulated in the explanation<sup>2</sup>. First, this implies that collaborating through collective bodies is materially different from working directly with other investors. In reality, a number of collective bodies consist solely of investors; making the distinction between bodies and investors slight. Secondly, this implies that collective bodies are a less effective method of collaboration. Often, collective shareholder organisations are far more effective at inciting

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<sup>2</sup> Paragraphs 12 and 13 on page 6.

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change at a regulatory and policy level, which may result in far reaching changes impacting whole markets.

Principle 6The use of proxy voting or other voting advisory services

*FRC considers disclosure could be improved in relation to the use of proxy advisory services in that companies are concerned that some investors appear to be uncritical in following their recommendations even when this conflicts with their own engagement activities. The proposed revisions in the guidance to Principle 6 request that signatories disclose not only whether they use these advisors but also the extent to which they use, rely upon and follow their recommendations.*

The use of, reliance on and adherence to proxy voting recommendations is not necessarily clear cut. Commonly most UK investors have a variety of approaches and the approach can vary according to the issues involved and the holdings. Thus smaller institutional investors may rely more on recommendations in relation to routine resolutions or in respect of smaller holdings, to allow more resource to be applied to major issues and holdings. Moreover, the high correlation between recommendations and resultant votes may be due to a number of factors and not as recommendations are blindly followed. For example, the UK Corporate Governance Code adopts a principles based approach which different investors and voting advisory services follow. Thus voting policies will be broadly consistent on issues such as director independence, resulting in a high correlation between investors' voting instructions and advisors' recommendations.

The amended guidance needs to allow for a variety of circumstances so that signatories explain their use of such services and consideration should be given to amending the text to address this. Clear disclosure of the use of advisory services will be beneficial when looking at these issues with interested parties, including the European Commission and ESMA.

Voting disclosure

*It is proposed that the guidance is amended so that it states that institutional investors should disclose publicly voting records and that the option to explain why not is removed.*

As demonstrated in our report on Adherence to the Stewardship Code for 2011<sup>3</sup>, increasingly institutional investors publicly disclose their voting records – up to 73.4 per cent of respondents in 2011 from 69 per cent in 2010. Of the 26.6 per cent (2010: 28.6 per cent) that do not, nine disclose publicly why they do not disclose and a further five explained that they consider their voting records are between themselves and their clients. To quote:

- *"[Manager] considers that the exercise of proxy votes on behalf of our clients to be a confidential issue between ourselves and our clients, and therefore we do not publicly disclose how we have acted on our clients' behalf."*
- *"We publish information for our European, Middle East and African clients on our voting record on the Fund Information page of our client website. Voting records for clients in other jurisdictions are also available and disclosure practices are based on best practices in those jurisdictions."*

With the exception of two out of 64 respondents in total, all report to their clients/beneficiaries. Moreover, to state that investors "should disclose" does not accord

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<sup>3</sup> <http://www.investmentfunds.org.uk/research/stewardship-survey/>

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with the main Principle which is that they should have a policy on voting disclosure. The text should continue to clarify that investors can explain why they do not.

Principle 7Assurance reports

*In March 2011, the Institute of Chartered Accountants in England and Wales issued a Stewardship Supplement to its AAF 01/06 guidance. Now this is in place, the FRC considers it would be appropriate to strengthen the wording in Principle 7, which it proposes should state that managers "should obtain" an assurance report, rather than "should consider obtaining" as in the existing Code. Asset managers can, of course, continue to explain rather than comply with the Code on this point.*

*Some asset owners have raised concerns with the FRC that they have been denied access to the assurance reports on their managers, or have been asked to pay an excessive amount for access. The FRC proposes to add state in Principle 7 that, if requested, clients should be provided access to such assurance reports.*

The Code is to be applied on a "comply or explain" basis but in many instances the proposed changes strengthen the text and we are concerned of the impact this may have on signatories that "explain". Non-adherence, even if accompanied by a valid explanation, may be viewed more negatively. This is particularly relevant in relation to Principle 7 on the independent verification of stewardship policies and the change from "should consider obtaining" to "should obtain". In addition, the introductory statement in paragraph 9 on page 4 that states: "*asset managers are expected to have the policies described in their stewardship statements independently verified*".

We note from our most recent report on Adherence to the Stewardship Code for 2011 that this is still an area of little take up, albeit that the stewardship supplement to the AAF 01/06 was only issued in March last year. For some, the concerns lie in how effectively the engagement process can be independently verified and the resultant costs.

While verifying voting information may be more feasible, certain of our members question the benefit of implementing an assurance process for engagement. Their concern is that quantitative and statistical reporting of engagement encourages a simplistic interpretation and that quantitative values do not provide insight into an investor's approach. Whilst they welcome the original purpose of the Code in encouraging more meaningful stewardship, they question whether an assurance process could effectively capture information that is not standardized and systematically recorded. It is not the quantity, but the quality of engagement and its impact that is important. This latter point remains a challenge, given that processes, intensity and time frames vary significantly and some outcomes may be easier to achieve than others. An assurance process could also prove to be time consuming and costly and they do not believe it would provide sufficient transparency or substantive information to demonstrate the quality and breadth of stewardship activities.

In view of this, we consider that paragraph 9 on page 4 should be amended and the Principle reverts to the original text. Moreover, it would be helpful if the Code made it clear that institutional investors may have their stewardship and voting processes reviewed by internal audit if they do not want to involve an external party.