



FINANCIAL REPORTING COUNCIL

REVISIONS TO THE UK STEWARDSHIP CODE

CONSULTATION DOCUMENT

APRIL 2012

INTRODUCTION

1. The FRC announced in December 2011 that it would consult on changes to both the UK Corporate Governance and Stewardship Codes, with a view to issuing revised versions of both codes that would apply to reporting periods beginning on or after 1 October 2012.
2. This consultation document seeks views on changes to the UK Stewardship Code. Consultation on changes to the UK Corporate Governance Code and the accompanying Guidance on Audit Committees is being carried out simultaneously.
3. The Stewardship Code traces its origins to 'The Responsibilities of Institutional Shareholders and Agents: Statement of Principles' which was first published in 2005 by the Institutional Shareholders Committee (ISC), and which the ISC converted to a code in 2009. Following the 2009 Walker Review of the corporate governance of UK banks and other financial institutions, the FRC was invited to take responsibility for the Code. In 2010, the FRC published the first version of the Stewardship Code, the contents of which were largely unchanged from the ISC code.
4. Launched only two years ago, the Code is in its infancy and the FRC recognises it will take time for its full impact to be felt. The FRC considers that it is appropriate at this stage in the life of the Code to build on a promising start by reinforcing it where necessary, but not fundamentally changing it. A similar view was expressed in the interim report of the Kay Review, published in February, which noted that "many respondents expressed satisfaction with the Code, within the terms of its objectives, and felt that it should be given time to settle". For that reason the FRC does not propose to change or add to the Code's seven principles.
5. That said, the draft revised Code does look rather different, particularly in the proposed introductory sections that are intended to replace the Preface. There are a number of reasons why this is the case.
6. First, it has become clear that there is no common understanding of what is meant by the term "stewardship", or of the respective roles and responsibilities of asset owners and managers. The revised Code attempts to provide greater clarity on these issues.

7. Second, when the FRC first published the Code in 2010 it recognised that some issues identified in its initial consultations – such as the question of whether institutional investors should recall lent stock for voting purposes – would need to be given further consideration when the Code was first reviewed. This consultation provides an opportunity to address some of those issues.
8. Finally, the consultation enables the FRC to take into account lessons learned during the initial implementation of the Code, many of which were highlighted in the FRC's 'Developments in Corporate Governance' report¹, published in December 2011, and to update the Code to reflect developments in market practice, such as the issuance of standards on assurance reporting and the FSA's requirement that firms authorised to manage funds on behalf of others disclose the nature of their commitment to the Code.

¹ The report can be found at <http://www.frc.org.uk/publications/pub2672.html>

HOW TO RESPOND

Comments on the proposed revisions to the Code set out in this consultation document are requested by 13 July 2012. Responses should be sent by e-mail to codereview@frc.org.uk

or in writing to:

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It is the FRC's policy to publish on its website all responses to formal consultations unless the respondent explicitly requests otherwise. A standard confidentiality statement in an e-mail message will not be regarded as a request for non-disclosure. We do not edit personal information (such as telephone numbers or email addresses) from submissions; therefore only information that you wish to be published should be submitted.

EXPLANATION OF THE PROPOSED REVISIONS

Rationale and summary of the proposed changes

1. As explained in the introduction, the proposed changes to the Code are intended to achieve a number of objectives. They seek to:
 - clarify the aim and definition of stewardship;
 - delineate more clearly the varying responsibilities of different types of institutional investors;
 - address issues identified in the FRC's December 2011 report;
 - address a small number of other issues fundamental to stewardship that previously had not been dealt with in the Code;
 - edit the previous text where needed to create greater consistency across the Code; and
 - provide more information, where needed, on how the Code is expected to be implemented.
2. Some of the changes to the draft Code are intended to address more than one of these objectives. In particular, the changes to the introductory sections of the Code – which have been reshaped along the lines of the equivalent sections of the UK Corporate Governance Code – address almost all of them.
3. Therefore, rather than repeating some of the proposals under a series of different headings, the remainder of this section groups them in the following way: changes identified in the 'Developments in Corporate Governance 2011' report; other substantive changes to the Code; and editorial changes that hopefully make the Code easier to follow.
4. The FRC is conscious of the need, when revising codes and standards, to resist the temptation continually to extend their scope and add unnecessarily to the level of detail. For this reason, in considering whether to propose changes to the Code, the FRC applied two tests:
 - When considering additions to the introductory sections of the Code: will the text assist signatories to the Code to understand better what stewardship is, the aim of stewardship, the purpose of the Code and how the Code is implemented?

- When considering adding new guidance to the principles of the Code: does the matter fundamentally impact an institutional investor's stewardship activity and, if so, can it be dealt with without undue prescription?

As well as commenting on the detail of the individual changes summarised in the remainder of this consultation document, views are invited on whether those changes meet these tests, and whether the Code as a whole is well-structured, balanced and clear.

Matters raised in 'Developments in Corporate Governance 2011'

The definition of stewardship

5. 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.

The roles of asset owners and asset managers

6. As the FRC noted in the December 2011 report, there is some confusion about the responsibilities of asset owners as contrasted with those of asset managers.
7. The proposed revisions made throughout the introductory sections and the Code itself are intended to identify more clearly the differing 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 carried out by owners and managers will vary depending on their circumstances.
8. Where a statement in the Code refers only to one type of firm the words "institutional investor" have been replaced with either "asset manager" or "asset owner". Where a statement refers to both managers and owners, the term "institutional investor" is used. Lastly, the word "shareholder" has been replaced with "investor", to avoid debate and confusion over whether the asset manager or owner is considered the shareholder.

9. The FRC acknowledges that categorising firms as “asset manager” or “asset owner” is a simplification and that firms may simultaneously engage in activities associated with both. For this reason, the proposed revisions in the introductory section note that “the division of duties within and between firms may span a spectrum, such that some may be considered more asset owners and others asset managers”, and invite signatories to consider where on the spectrum they reside.

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

Conflict of interest policies

10. In its December 2011 report, the FRC expressed the view that the reporting in signatories’ statements of how conflicts of interest were managed was frequently weak, noting that relatively few signatories stated categorically they always sought to place the interest of their clients first.
11. The proposed revisions to Principle 2 aim to encourage more informative disclosure, while recognising that the interests of clients may vary. The draft wording is intended to be consistent with the requirements in the Financial Services Authority’s Handbook for common platform firms to “take all reasonable steps to prevent conflicts of interest from giving rise to a material risk of damage to the interests of clients” and “implement and operate an effective written policy for identifying and managing conflicts of interest”².

Collective engagement

12. Many statements by Code signatories on collective engagement focus only on membership of collective bodies. While this is welcome, it skirts round the main reason for this principle, which is to establish whether the signatory is willing and able to join forces with other investors at critical moments.
13. 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.

² More details can be found in the Senior Management Arrangements, Systems and Controls section of the FSA Handbook: <http://fsahandbook.info/FSA/html/handbook/SYSC/10>

The use of proxy voting or other voting advisory services

14. The third specific area in which the FRC considers disclosure could be improved relates to the use of proxy advisory services. The existing Code (in the guidance to Principle 1) asks signatories to state whether and how they use proxy voting or other voting advisory services. However, many statements do not provide the information needed to assess the quality of the signatory's stewardship activities, for example whether they apply their own voting policy or always follow that of the advisory service.
15. As noted in the FRC's December 2011 report, many companies continue to be concerned that some investors appear to be uncritical in following the recommendation of proxy advisors even when this conflicts with their own engagement activities. This is an issue both for market operation as well as public policy. The use by investors of proxy advisory services is being actively debated in the EU, with several Member States pressing the European Commission for regulation. Critical to the outcome will be the way in which investors use the recommendations provided by proxy advisors. A clear sense that they are being used to inform, rather than substitute for, investors' stewardship activities could help alleviate pressure for prescriptive regulation.
16. The proposed revisions (which appear in the guidance to Principle 6) therefore 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.

Stock lending

17. The issue of stock lending was raised by many respondents when the FRC first consulted on whether to take ownership of the ISC's Code in 2010. At that time the FRC decided not to make substantive changes to the Code, but noted that this issue would be looked at again when it was first reviewed.
18. The FRC considers that it would now be appropriate to add a reference to stock lending to the Code. The issue is of fundamental importance to stewardship because of its impact on the institutional investors' ability to vote shares owned.
19. The new language appears in the guidance to Principle 6. It does not express a view on the rights or wrongs of stock lending, but asks signatories to disclose their policy on the issue, and specifically whether they recall lent stock for voting purposes. The suggested wording mirrors that in the 'Code for External Governance' published in April 2011 by the European Fund and Asset Management Association.

Other asset classes

20. The focus of the Code to date has been on UK equities, with one of its primary objectives being to enhance engagement with UK listed companies. However, the FRC recognises that these equities may only be small part of an institutional investor's portfolio and that clients and beneficiaries may wish to see the Code's principles applied to other parts of that portfolio. Separately, a number of clients have told the FRC that it is unclear from some signatories' statements whether they apply the Code's principles to some or all of their funds under management.
21. The proposed revisions to the introductory section therefore encourage disclosure of whether the signatory applies its stewardship approach to other asset classes, including overseas equities, and to identify to which of the products under management the statement is applied.

Assurance reports

22. In March 2011, the Institute of Chartered Accountants in England and Wales issued a Stewardship Supplement to its AAF 01/06 guidance on assurance reports on internal controls of service organisations. The guidance aims to provide an approach to reporting that minimises bureaucratic interference while providing clients and beneficiaries with appropriate assurance. Separately, at international level the Statement on Accounting Standards No. 70 has been replaced with the Statement on Standards for Attestation Engagements No. 16. The guidance to Principle 7 is revised to note these changes.
23. Now that the AAF guidance 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.
24. 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 believes that this undermines the purpose and credibility of obtaining independent assurance, and therefore proposes to add state in Principle 7 that, if requested, clients should be provided access to such assurance reports.

Relevance of signatories' statements

25. 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.

Other Substantive Changes to the Code

Insider information, acquisitions and sub-underwriting

26. In its December 2011 'Rights Issues Fee Inquiry' report, the Institutional Investors Committee (IIC) recommended that institutional investors consider appointing a named individual who can be taken "off market" and speak to issuers and their advisors with authority on matters such as support for a rights issues, pricing and sub-underwriting. The IIC also recommended that the FRC should consider how to encourage asset owner participation in equity sub-underwriting in its review of the Stewardship Code.
27. The FRC agrees with the IIC that the processes around rights issues could be smoothed if institutional investors were to appoint a named individual and indicate whether or not they were willing to participate in equity sub-underwriting. However the FRC considers that the specific recommendations made by the IIC are more prescriptive than is appropriate for the Code.
28. That said, 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 become insiders indicate as much in their stewardship statement.

FSA disclosure requirements

29. The Financial Services Authority introduced in December 2010 a requirement for all firms authorised to manage funds on behalf of others to disclose "the nature of its commitment" to the Code or "where it does not commit to the Code, its alternative investment strategy" (under Conduct of Business Rule 2.2.3). Those that do commit are expected under the terms of the Code to "comply or explain" with its principles and report on how it has been applied. These requirements are summarised in the introductory sections of the Code, while making it clear the choice of whether or not to apply the Code remains voluntary.

The role of service providers

30. The proposed revisions to the introductory sections emphasise that service providers play a supporting role in promoting stewardship on behalf of their institutional investor clients, to whom the Code is addressed in the first instance. Those proposed revisions explicitly recognise that “service providers” include investment consultants and providers of engagement overlay services as well as proxy advisors, as readers may have inferred from the current wording of the Code that service providers referred only to proxy advisors and other voting advisory services.

Editorial changes

31. This consultation provides the opportunity not only to clarify points that have been raised during the initial implementation of the Code but also to improve the structure and provide supporting text to facilitate its implementation. These changes are detailed below.

The Preface

32. As already noted, the FRC proposes to transform the Preface into three sections, following the structure used in the UK Corporate Governance Code. The first section defines stewardship, introduces the Code and articulates its relationship to the UK Corporate Governance Code. The second section highlights issues regarding the implementation of the Code. The third, new, section explains how “comply or explain” works in relation to the Code.

Guidance to Principle 1

33. To avoid repetition, items that are dealt with in the subsequent principles have been deleted from Principle 1. For example, the statement regarding keeping a record of stewardship activities is proposed to be moved from the guidance to Principle 1 to the guidance to Principle 7. Instead, the FRC proposes incorporating a summary of some of the points in the introductory section in the guidance.

Principle 2

34. In Principle 2 the word “robust” is replaced with “effective” as signatories expressed concerns that it was difficult to demonstrate “robustness”. The FRC recognises that the same might be said of “effectiveness”, and would welcome views on how this principle might best be worded. One benefit of using the word “effective” would be to ensure consistency with the wording used in the FSA Handbook (see paragraph 11).

Guidance to Principles 3 and 4

35. The first three bullet points of the second paragraph of Principle 3 have been added better to align this guidance with items flagged for escalation in the guidance to Principle 4. In turn, those items have been extended to refer to remuneration and all risks associated with the company (the current Code refers only to risks arising from social and environmental matters).

Principle 4

36. A proposed revision is to remove the phrase “as a method of protecting and enhancing shareholder value” from Principle 4 since this objective relates to all the principles, not just Principle 4. The FRC proposes instead that this wording should introduce the list of the principles under the section entitled ‘The Principles of the Code’, and appear in the guidance to Principle 1.

Guidance to Principle 5

37. The last paragraph of the guidance to Principle 5 is deleted as conflicts of interest and insider information are dealt with in Principle 2 and the guidance to Principle 3, respectively.

Views are invited on all of the proposed revisions to the Code summarised above.



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