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UK Stewardship Code: Guidance for Investors

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1. Executive Summary

The Financial Reporting Council (FRC) published the UK Stewardship Code (the Code) in July 2010. The Code is designed to lay out the responsibilities of institutional investors as shareholders and provide guidance as to how those responsibilities might be met. Pension fund trustees and other investors are 'strongly encouraged' to 'report if and how they have complied with the Code' and this document is designed to assist investors, particularly pension funds, in meeting their obligations under the Code.

The Stewardship Code consists of seven key Principles:

Principle 1: Institutional investors should publicly disclose their policy on how they will discharge their stewardship responsibilities.

Principle 2: Institutional investors should have a robust policy on managing conflicts of interest in relation to stewardship and this policy should be publicly disclosed.

Principle 3: Institutional investors should monitor their investee companies

Principle 4: Institutional investors should establish clear guidelines on when and how they will escalate their activities as a method of protecting and enhancing shareholder value.

Principle 5: Institutional investors should be willing to act collectively with other investors where appropriate.

Principle 6: Institutional investors should have a clear policy on voting and disclosure of voting activity.

Principle 7: Institutional investors should report periodically on their stewardship and voting activities.

The Stewardship Code is seen by the FRC as complementary to the UK Corporate Governance Code for listed companies and, similarly to that Code, it should be applied on a 'comply or explain' basis. We suggest that as a minimum, all pension funds should disclose:

- Whether they support the Code's Principles and if not, why not;
- Whether reference is made to the Code in the SIP and/or IMAs;
- The review process and its frequency (eg annual consultant assessment; manager report and/or meeting); and
- The managers used by the fund and whether they apply the Code.

The FRC will undertake annual monitoring of the take-up and application of the Code, which will begin in full in the second half of 2011. An interim monitoring exercise will take place in the first year of the Code, the results of which will be available in a report to be published in March 2011.

2. Introduction

2.1. The UK Stewardship Code (the Code) was published by the Financial Reporting Council (FRC) in July 2010. The Code builds on the well established Institutional Shareholders' Committee's *Statement of Principles on the responsibilities of shareholders and agents.* It is designed to lay out the responsibilities of institutional investors as shareholders and provide guidance as to how those responsibilities might be met. While it is aimed in the first instance at the asset managers (and particularly those who are regulated by the Financial Services Authority), pension fund trustees and other investors are "strongly encouraged"to "report if and how they have complied with the Code". This document is designed to assist investors, particularly pension funds, in meeting their obligations under the Code.

2.2. The NAPF is a strong supporter of the Code and encourages pension funds to sign up to it.

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3. Background

3.1. The Stewardship Code should be seen in the context of the wider response to the financial crisis, which many perceive as having its roots, in part at least, in an excessive focus on short-termism by market participants, including pension funds and their agents. An inevitable part of that response is for the regulators to examine the effectiveness of the regulatory regime and to seek to 'improve' it in order to prevent similar excesses occurring in the future.

3.2. The European Commission and the Department for Business, Innovation and Skills have both signalled their intent to re-examine many of the fundamental premises which underlie investment markets and to ask whether the markets can be relied on to operate in the interests of the economy as a whole.

3.3. The Stewardship Code complements the UK Corporate Governance Code. Both encourage better dialogue between shareholders and companies with the objective of raising standards of corporate governance. The NAPF believes that long-term investors should support this ambition as those businesses which are well governed, in the interests of their shareholders, are more likely to deliver sustained and acceptable rates of return. The Code should therefore have widespread support from end-owners such as pension funds, as well as their agents, the asset managers and investment consultants.

4. Regulatory Framework

4.1. The Code follows the 'comply or explain' approach which has underpinned the various corporate governance codes which have applied to listed companies for many years. It has proved effective in gradually raising standards while at the same time giving scope, which would not be available under legislation, for companies to apply different standards depending on their own specific circumstances. Thus the Stewardship Code can be applied by a wide variety of investors in many different ways, ranging from the extreme of an explanation for non-compliance to full compliance.

4.2. Investors, including pension funds, are expected to apply the Code in whatever way is appropriate to their business model and make public their compliance statement. For example, it is possible that an asset manager's investment process may exclude some or all forms of engagement, in which case an explanation for non-compliance with the Code should be provided. For pension funds, application of the principles will depend on several factors, including the trustees' investment strategy and the extent to which investment management is outsourced.

4.3. Our understanding is that while the FRC refers to publication on a website, where a fund does not have a website the FRC would be happy to host the statement, including contact details, on its web page which hosts the list of signatories to the Code (FRC contact: Jocelyn Brown: 0207492 2379 or j.brown@frc.org.uk). Funds should also include the statement in their annual report. At the end of this section we set out what that statement should include.

4.4. The FRC will undertake annual monitoring of the take-up and application of the Code, which will begin in full in the second half of 2011. An interim monitoring exercise will take place in the first year of the Code, which will include a questionnaire conducted by the IMA under the oversight of an independent steering group, and a joint-monitoring exercise reviewing the policy statements of signatories conducted by the FRC and IMA. The results from both strands of interim monitoring activity will be available in a report to be published in March 2011, with the permanent monitoring activities commencing later in 2011.

4.5. Pension funds are encouraged to use the FRC list when appointing or reviewing investment managers.

4.6. While the FSA-regulated firms were encouraged to publish their compliance statements by 30th September, other entities such as pension funds do not have a deadline as yet. However, the FRC will carry out regular monitoring of the take up of the Code and can be expected to review the effectiveness of the 'comply or explain' regime in due course.

4.7. The FSA recently confirmed that it will amend its Conduct of Business Sourcebook to require relevant firms to explain their commitment to the Code. Its statement reads as follows:

> *"This instrument requires firms (other than venture capital firms) managing investments for a professional client to disclose the nature of their commitment to the Stewardship Code, or their alternative investment strategy. The Stewardship Code outlines good practice with regard to institutional investors' engagement with the boards of firms in which they invest and is overseen by the Financial Reporting Council."*
>
> The new rule, COBS 2.2.3R, comes into force on 6th December 2010.

4.8. While most pension funds are not FSA-regulated, their investment managers often are. The FSA will regard non-compliance with the new rule as it would any other breach of its Conduct of Business requirements.

5. Principles

Principle 1: Institutional investors should publicly disclose their policy on how they will discharge their stewardship responsibilities.

5.1. The FRC guidance on disclosure refers specifically to company monitoring, engagement and intervention. It also covers integration of stewardship into the investment process, voting policy (including the use of voting advisory services), and how investors address explanations in relation to the UK Corporate Governance Code.

5.2. Trustees should consider whether reference to compliance with the Code should be included in the Statement of Investment Principles and/or Investment Management Agreements (IMAs). Given the requirement under the SRI pensions Disclosure Regulation 2000 that 'trustees of occupational pension funds disclose in the Statement of Investment Principles (SIP) the extent (if at all) to which social, environmental and ethical (SEE) considerations are taken into account in their investment strategies', there is a logic in incorporating it into the SIP. However, funds may wish to give the Code greater prominence, bearing in mind that it goes some way beyond a disclosure and SEE requirement, and build a reference into IMAs.

5.3. In the case of most pension funds, investment management, including stewardship, is delegated to an asset management firm, selected on advice from their investment consultants. Funds should satisfy themselves that they have in place a process for monitoring how their asset managers apply the Code and the input of their consultants into that process. For segregated accounts, funds should check if their preferred manager is applying the Code as part of the appointment process and agree what represents an acceptable standard, which will vary depending on the fund's stewardship policy and on the mandate.

5.4. Where a fund uses a pooled fund a similar approach should apply, albeit that there is minimal scope for negotiation.

5.5. We expect that most funds will review stewardship as part of their periodic manager evaluation. An examination of a manager's application of the Code may, in the case of an active manager, provide some useful insights into how the investment process has been applied.

5.6. Many funds use more than one manager. The review should cover all, regardless of whether they claim compliance with the Code.

5.7. Funds with in-house investment management capabilities are expected to apply the Principle as is appropriate to their investment process and to provide disclosure (either directly or through their investment management arm) which is comparable to that of an independent asset manager.

5.8. Defined contribution pension funds which are trust-based face their own challenges in meeting the requirements of the Code. The funds selected for their fund will have their own stewardship policy and reporting standards. Trustees may choose to take these into account when selecting investment managers. They will also have to decide on what is the most effective way of reporting to their members. Web-based tools will suit most but not all.

5.9. The Principle requires that "…investors should publicly disclose their policy….". While the FRC encourages the use of websites, it recognises that many funds may not have a website where such information can be easily displayed. In those cases, funds are encouraged to use the FRC facility referred to earlier and include a statement in the annual report.

5.10. We suggest that as a minimum, all funds should disclose:

- Whether they support the Code's Principles and if not, why not;
- Whether reference is made to the Code in the SIP and/or IMAs;
- The review process and its frequency (eg annual consultant assessment; manager report and/or meeting); and
- The managers used by the fund and whether they apply the Code.

Principle 2: Institutional investors should have a robust policy on managing conflicts of interest in relation to stewardship and this policy should be publicly disclosed.

5.11. The FRC acknowledges that conflicts will arise from time to time and that these need to be managed. Pension funds are already required to have a conflicts management policy, which does not specifically refer to investment-related conflicts. We suggest that this will usually be sufficient to address this Principle, at fund level.

5.12. However, funds may face a particular challenge where a conflict arises between the sponsor, or a beneficiary, and the companies in which the fund invests. They may wish to establish a policy for addressing such a conflict before it develops.

5.13. Where third-party managers are used, conflicts may involve a parent company or other clients, for example. Funds should ensure that any such issues are disclosed as part of the reporting procedures, possibly outwith the routine reports. Funds may want, in exceptional circumstances, to be consulted ahead of any action by their manager.

5.14. Funds which use an in-house investment manager will inevitably face difficult issues from time to time (eg a takeover or corporate governance breach involving a competitor). It is reasonable for the manager to refer such issues to the trustees for decision. They in turn may choose to take advice from a specialist advisory firm in order to ensure that their decision is seen to be taken solely in the interests of the fund and its beneficiaries.

5.15. Pooled funds present different challenges from segregated accounts as funds have less control over the management of conflicts as they happen.

Principle 3: Institutional investors should monitor their investee companies

5.16. FRC guidance is built around why, when and how institutional investors should engage, as well as stressing the importance of maintaining a clear audit trail of that engagement.

5.17. For most pension funds the application of this Principle will be delegated to their investment managers. Thus their responsibility is to monitor this as part of their review process.

5.18. Managers, both internal and external, should be expected to set out how this Principle has been applied, including descriptions of the process and a record of monitoring activity. It should not usually be sufficient to assert compliance with it.

Principle 4: Institutional investors should establish clear guidelines on when and how they will escalate their activities as a method of protecting and enhancing shareholder value.

5.19. FRC guidance notes that investors should assess the effectiveness of their engagement and should have clear guidelines for escalation.

5.20. Pension funds should ensure that this Principle forms part of the arrangements with their investment managers, including reporting. However, they should be aware that in some circumstances their managers may prefer to keep their intervention activity confidential, in order to facilitate a successful outcome. We encourage investment managers to inform their clients of situations where they believe that their intervention has contributed to change at a company.

Principle 5: Institutional investors should be willing to act collectively with other investors where appropriate.

5.21. The FRC guidance notes that collective engagement can be more effective in certain circumstances and that investors should disclose their policy.

5.22. The NAPF has, through its Case Committees, been a firm supporter of collaborative engagement for a considerable time. We believe that funds should ask their managers to set out their approach and encourage greater collaboration, on a case by case basis. Managers can be reluctant to collaborate for competitive reasons – their clients should be aware of this.

5.23. As most funds hold only a very small percentage of equity in individual companies, there are strong reasons for them as the asset owners to collaborate in order to make their voice heard and a number of larger funds have begun to do so, through the NAPF or independently of it, or through the advisory firms which offer an engagement service. We welcome these developments and encourage more funds to explore the possibility of collaboration as circumstances dictate.

Principle 6: Institutional investors should have a clear policy on voting and disclosure of voting activity.

5.24. The FRC guidance supports the considered use of votes at company meetings and public disclosure of voting records.

5.25. Funds should expect their managers to exercise their voting rights in all markets unless it is against their clients' interests to do so. A clear policy should be established at the start of the contract, covering: which markets will be voted; how the voting guidelines are set; the process for exercising votes, including engagement; how voting activity is to be reported. Managers should be discouraged from using boilerplate reporting which fails to provide sufficient explanation for decisions which are high-profile or in conflict with policy.

5.26. Public disclosure of voting records on a fund basis presents significant practical problems, due to the use of several managers and the absence of a suitable means of publishing such data. We expect most to explain this and refer to the voting records published by their third-party investment managers. Where a fund uses an in-house manager it may be necessary to publish voting records in the absence of a suitable explanation.

Principle 7: Institutional investors should report periodically on their stewardship and voting activities.

5.27. The FRC notes that reporting should be qualitative as well as quantitative. Pension funds are expected to report at least annually on their policy and its execution.

5.28. We believe that the use of AAF01/06 or SAS 70 reports can provide a useful independent audit of the engagement and voting processes, although it should be noted that they provide no assurance as to the effectiveness of a firm's stewardship of its clients' investments. We encourage pension funds to request such reports from their investment managers and to use them as part of their periodic evaluation process.

5.29. The precise structure and content of manager reports and reviews by a fund's advisers will vary depending on the size and complexity of the fund as well as the different investment mandates it has awarded. We believe that the investment consultants have an important role to play in the review process and should be able to highlight for their clients the strengths and weaknesses of their investment managers, based on their application of the Code's Principles. We encourage funds and their advisers to make use of examples of both strong and weaker practice in their reports.

5.30. As noted earlier pension funds should incorporate appropriate reporting into their annual report and accounts. Some may choose in addition to refer to their stewardship policy in other communications with fund members.

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