UK Stewardship Code – New Conduct of Business rule

Introduction

The Stewardship Code was published by the Financial Reporting Council ('FRC") in July 2010. It aims to enhance the quality of engagement between institutional investors and companies to help improve long term returns to shareholders and the efficient exercise of governance responsibilities.

It applies primarily to firms that manage assets for institutional shareholders such as pension funds, insurance companies, investment trusts, and other collective investment vehicles.

Engagement with investee companies and compliance with the Code are not mandatory, however the Code sets out good practice on engagement with investee companies which the FRC believes institutional investors should aspire to. The FRC strongly encourages all institutional investors to report if and how they have complied with the Code.

For firms which are committed to the Code, it is applied on a 'comply or explain' basis. In reporting terms, this entails providing a statement on the institutional investor's website that contains:

- a description of how the principles of the Code have been applied;
- disclosure of the specific information listed under Principles 1, 5, 6, & 7; and
- an explanation if these elements of the Code have not been complied with.

The FRC recognises that not all parts of the Code will be relevant to all institutional investors, as some smaller firms may judge that some of its principles are disproportionate in their circumstances. In this case, the FRC considers that firms should take advantage of the 'comply or explain' approach and set out why this is the case.

The FRC will retain on its website a list of those investors that have publicised a statement on their compliance or otherwise with the Code, and requests that they notify the FRC when they have done so.

FSA Rules

Following the publication of this Code, and in support of the Code, the FSA consulted on a new rule to be introduced as part of Conduct of Business rules. This required that 'a firm (other than a venture capital firm) which is managing investments for a professional client that is not a natural person must disclose the nature of their commitment to the Code on their website or where it does not commit to the Code, its alternative investment strategy'. This was detailed in CP10/15 in July 2010. Following this consultation, final rules were issued on 12 November 2010 confirming this new rule requirement. This is being implemented under COBS 2.2.3 with effect from 6 December 2010.

Only one disclosure is required regardless of the number of funds that the investment manager manages. This can be based on general investment strategy with the statement that this may vary from client to client depending upon the relevant mandate. The disclosure however should be clear.

The FSA rules are not equivalent to requiring all firms to comply with the Code. As detailed above, engagement with investee companies and committing to the Code is not mandatory. However the FSA rules are seeking transparency so that it is clear to investors or clients the nature of a firm's commitment or otherwise to the Code. Therefore the disclosure of the firm's position on the Code is mandatory under the new rules.

The FSA recognises some firms focus more on trading than engagement. Where this is the case, the disclosure may involve no more than a statement, that because of its chosen investment strategy, engagement does not occur and the firm does not consider its clients expect such engagement. Therefore where the firm's investment approach does not support commitment to the Code, the firm should disclose this.

Summary of Stewardship Code Principles

Where the firm is committed to following the Stewardship Code, there are seven principles in total which are that firms should:

1. publicly disclose their policy on how they will discharge their stewardship responsibilities
2. have a robust policy on managing conflicts of interest in relation to stewardship and this policy should be publicly disclosed
3. monitor their investee companies
4. establish clear guidelines on when and how they will escalate their activities as a method of protecting and enhancing shareholder value
5. be willing to act collectively with other investors where appropriate
6. have a clear policy on voting and disclosure of voting activity
7. report periodically on their stewardship and voting activities.

Next steps

Investment managers need to consider the Stewardship Code and decide whether they can commit to the Code at present (or if not, whether this is something that it should be aspiring to). An appropriate Stewardship Code disclosure should be added to the firm's website as soon as possible, outlining whether the firm is committed to the Code, and if so, how it satisfies its principles including specifically Principles 1, 5, 6, and 7.

Where a firm is committing to the Code, guidance on the type of behaviours and disclosures required is outlined in the Code itself. Where the firm is not committing to the Code, it should state this and state its alternative investment strategy regarding engagement.

This briefing paper provides a summary of the Stewardship Code and the new Conduct of Business rule. It is general advice, not firm specific and provides only a summary of the issues involved. For firm specific guidance, please contact Gillian Gallacher for further assistance.