



FINANCIAL REPORTING COUNCIL

**CONSULTATION ON A STEWARDSHIP CODE
FOR INSTITUTIONAL INVESTORS**

JANUARY 2010

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1 INTRODUCTION

- 1.1 The concept of active share ownership is central to the regulatory framework for the governance of listed companies in the UK. Directors are required under law to act in the interest of the members of the company (shareholders), and under Section 172 of the Companies Act 2006 are expected to pursue “enlightened shareholder value” in order to promote the long term success of the company.
- 1.2 Shareholders in turn are expected to take action where they believe that the directors are not best serving their own or the interests of the beneficial owners (including pensioners, insurance company policyholders and unit trust investors), and the law provides them with voting and other rights to enable them to do so. Given the weight of their votes, the way in which institutional shareholders use these rights is of fundamental importance. While shareholders cannot and should not be involved in the management of their company, they can insist on a high standard of corporate governance as a long-term driver of good investment performance. The extent to which they do this turns on the degree to which they take on the responsibilities of owners, either directly or as the managers of the money given to them by retail and other investors.
- 1.3 Where the beneficial owners of shares have hired institutional shareholders and delegated to them the duty to act on their behalf, it is their responsibility to ensure that the asset managers act diligently and in the best interest of the ultimate owners.
- 1.4 The governance standard for UK listed companies is the Combined Code on Corporate Governance (which is to be renamed the UK Corporate Governance Code). This operates on the basis of “comply or explain”, which allows companies the flexibility to deviate from the provisions of the Code provided they explain to their shareholders the reasons for doing so. Shareholders are then expected to judge the explanation on its merits and either accept or challenge it. The effectiveness of this approach depends on sufficient investors being willing, directly or indirectly, to put resources into engaging actively with the companies in which they invest.

- 1.5 The FRC's December 2009 report on its review of the Combined Code¹ found that there continued to be strong support for the "comply or explain" approach from both companies and investors, but there were significant concerns about the quantity and effectiveness of engagement between institutional investors and boards of listed companies.
- 1.6 These concerns were also voiced by Sir David Walker in his review of the governance of banks and other financial institutions. In his final report published in November 2009, Sir David concluded that: "*...there is a need for better engagement between fund managers acting on behalf of their clients as beneficial owners, and the boards of investee companies. Experience in the recent crisis phase has forcefully illustrated that while shareholders enjoy limited liability in respect of their investee companies, in the case of major banks the taxpayer has been obliged to assume effectively unlimited liability. This further underlines the importance of discharge of the responsibility of shareholders as owners, which has been inadequately acknowledged in the past... there should be clear disclosure of the fund manager's business model, so that the beneficial shareholder is able to make an informed choice when placing a fund management mandate*".
- 1.7 The Walker Review made certain recommendations concerning institutional investors, in order to improve the ability of their clients to make such informed choices. These were that:
- the FRC's remit should be extended to cover the development and encouragement of adherence by institutional investors to best practice in stewardship of UK listed companies;
 - the Code on the Responsibilities of Institutional Investors, prepared by the Institutional Shareholders' Committee, should be ratified by the FRC and should operate as a Stewardship Code on a comply or explain basis, and should be reviewed by the FRC on a regular basis;
 - arrangements should be put in place under the guidance of the FRC for appropriately independent oversight of a monitoring process, with an annual engagement survey; and
 - the Financial Services Authority (FSA) should require institutions that are authorised asset managers to disclose on their website whether and, if so, how they commit to the Stewardship Code.

¹ FRC 2009 Review of the Combined Code: Final Report, published 2 December 2009: <http://www.frc.org.uk/images/uploaded/documents/2009%20Review%20of%20the%20Combined%20Code%20Final%20Report1.pdf>

- 1.8 The Review also stated that foreign investors should be encouraged to commit to the Stewardship Code on a voluntary basis in the belief that this was likely to be in their own interests and in that of their clients as ultimate beneficiaries.
- 1.9 The Government has asked the FRC to accept responsibility for a Stewardship Code. The FRC welcomes the opportunity to assist constructive engagement, which should underpin good corporate governance in investee companies and thus complement the FRC's existing responsibility for promoting high standards of corporate governance in the Combined Code. The FRC has therefore agreed to take on this new responsibility, subject to ensuring that such a code can be operated effectively.

Policy objectives

- 1.10 The FRC believes that the Stewardship Code can contribute to a significant improvement in the stewardship of UK listed companies.
- 1.11 The potential benefits are large. More effective engagement should improve the governance and performance of investee companies, assist the efficient operation of capital markets and increase confidence in business. Greater clarity in the respective responsibilities of asset managers and asset owners and strengthened accountability of institutional shareholders to their clients will also strengthen trust in the financial system. A clear understanding of these responsibilities will also assist beneficial owners in setting the terms of their fund mandates and in holding asset managers accountable.
- 1.12 These benefits will not be achieved if the Code is ignored. That is why the Walker Review proposed that the FSA consult on a requirement in its rulebook that authorised investment firms should state whether they comply with the Stewardship Code or explain their non-compliance.
- 1.13 The FRC also looks to the clients of institutional shareholders to support the development of the Stewardship Code, as shareholders have supported the development of the Combined Code over the years. In particular, owners need to consider whether they could better align the performance goals in their mandates with their savers' long-term interest in market stability.

1.14 **The FRC has identified the following policy objectives against which to judge a Stewardship Code, on which it would welcome views.** These are that the Code should:

- Set standards of stewardship to which mainstream institutional investors should aspire, and maintain the credibility and quality of these standards through independent input on the content and monitoring of the Code;
- Promote a sense of ownership of the Code amongst institutional investors in order to encourage UK and foreign shareholders to apply and report against it;
- Ensure that engagement is closely linked to the investment process within the investment firm;
- Contribute towards improved communication between shareholders and the boards of the companies in which they invest; and
- Secure sufficient disclosure to enable institutional shareholders' prospective clients to assess how those managers are acting in relation to the Code so that this can be taken into account when awarding and monitoring fund management mandates.

Proposals

1.15 Sir David Walker considered that the code published by the Institutional Shareholders' Committee in November 2009 provided a good starting point for the Stewardship Code. The ISC Code is reproduced in Appendix B.

1.16 **The FRC is seeking views on whether it should accept oversight of the Code in its current form, or whether amendments should be made before the FRC does so.**

1.17 **Views are also sought on which institutional investors and agents should be encouraged to apply the code on a "comply or explain" basis, what they should be asked to disclose and to whom, and the monitoring arrangements that should be put in place. Specific questions are asked throughout the document and summarised in Appendix A.**

- 1.18 The Code is aimed at institutional investors and their agents. However, it will not succeed in its aims unless listed companies welcome both the Code and the greater engagement that it is hoped will follow. The FRC would therefore greatly welcome views from companies and their representatives. In addition, given the fact that foreign investors own a large percentage of the UK market, the FRC would also greatly welcome views from those investors and their representatives.
- 1.19 The FRC will publish a regulatory impact assessment when issuing the Stewardship Code in its final form. It would particularly welcome information from institutional shareholders active in investing in UK companies on the likely costs and benefits arising from the proposed code and the different options for reporting and monitoring.
- 1.20 The proposed FSA disclosure rule will be subject to separate consultation at a later date.

How to comment

Comments on the proposals set out in this consultation document are requested by 16 April 2010. The intention is that the outcome of the consultation will be announced in May or June.

Responses should be sent by e-mail to stewardshipcode@frc.org.uk

or in writing to:

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

It is the FRC's policy to publish on its website all responses to formal consultations issued by the FRC and/or any of its Operating Bodies 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.

2 BACKGROUND AND RECENT DEVELOPMENTS

- 2.1 The proposal for an FRC sponsored Stewardship Code is not the first initiative to encourage institutional investors to engage with the companies in which they invest. The most important historical and recent developments are summarised briefly in this section.

The Institutional Shareholders' Committee Code

- 2.2 The Institutional Shareholders' Committee (ISC) is a forum of UK trade associations formed to allow the UK institutional shareholding community to exchange views and, on occasion, co-ordinate their activities in support of the interests of UK investors. It currently consists of the Association of British Insurers, the Association of Investment Companies, the Investment Management Association and the National Association of Pension Funds.
- 2.3 In 1991, the Institutional Shareholders' Committee published a statement on "The Responsibilities of Institutional Shareholders in the UK".
- 2.4 In 2000, Paul Myners was asked to carry out a review of institutional investment by the Chancellor of the Exchequer. His Report² was published in 2001 and set out principles for investment decision-making for pension fund trustees ("the Myners Principles"), including a recommendation on incorporating shareholder activism into fund management mandates. In response, the ISC developed best practice guidance for the investment industry by way of its 2002 Statement of Principles on the responsibilities of institutional shareholders and their agents in respect of investee companies. This statement was reviewed and reissued in 2004 and 2007.
- 2.5 In June 2009, the ISC announced its intention to convert its Statement of Principles into a code. This new code³ was published in November 2009, and can be found at Appendix B. The ISC Code goes further than the 2007 Statement of Principles that it replaces in a number of respects. In particular, the Code includes:

- A new recommendation on disclosure by investors on the use of advisory services from proxy voting agencies;

² Myners Review 2001: <http://www.hm-treasury.gov.uk/d/31.pdf>

³ Institutional Shareholders' Committee Code 2009:
<http://institutionalshareholderscommittee.org.uk/sitebuildercontent/sitebuilderfiles/ISCCode161109.pdf>

- Changes to the wording to encourage investors to consider explanations made rather than compliance by listed companies against the Combined Code; and
 - Greater prominence to managing conflicts of interest, including a new principle on this issue.
- 2.6 The ISC Code is voluntary but calls on institutions to state publicly how they apply its principles and disclose what steps they have taken, or intend to take, to verify their compliance. The voluntary nature of the ISC Code is intended to encourage investors that may not be members of ISC bodies, such as foreign fund managers and sovereign wealth funds, to sign up to the Code. The ISC has proposed that those investors – whether UK or foreign – that choose to comply with the Stewardship Code may be listed on the ISC website.
- 2.7 The ISC is also reviewing its constitution and is currently in the process of forming a committee including representation from senior investors, the main investment trade associations and corporate governance practitioners. The committee will consult on new arrangements for the ISC and expects the new arrangements to be in place later in 2010.

Other UK developments

- 2.8 Since 1998, the Combined Code has contained a section (Section E) that addresses a number of non-binding recommendations addressed to institutional investors, including that they should make considered use of their votes and be ready to enter into a dialogue with companies. Introducing these recommendations, the Hampel Committee expressed the hope that “at least the major institutions will voluntarily disclose to their clients and the public the extent to which they are able to give effect to these provisions”. In its December 2009 report, the FRC proposed to remove this section subject to sufficient progress being made on the new Stewardship Code.
- 2.9 In 2004, the Myners Shareholder Voting Working Group published a report⁴ on difficulties in the voting process, which noted that “the chain of accountability is complex... there is a lack of transparency and ... a large number of different participants, each of whom may give a different priority to voting.”

⁴ Review of the Impediments to Voting UK Shares: Report by Paul Myners to the Shareholder Voting Working Group: January 2004

- 2.10 In 2005, the investment consultant community issued a statement⁵ setting out their support for the ISC Statement of Principles and some practical steps to assist consultants to encourage and enable trustees to consider around the inclusion of engagement in their mandates and the assessment of the competencies of fund managers on engagement.
- 2.11 In 2006 the Government took powers under the Companies Act⁶ to require institutional investors to disclose how they had voted their shares, but stated that it intended to use this power only if a voluntary regime were to fail to improve disclosure and only after full consultation. These powers have not yet been used. In response, the ISC published in June 2007 a voluntary framework⁷ designed to help UK institutions develop policies on the public disclosure of votes. In 2002, only two institutions had publicly disclosed their votes; by 2008 24 institutions did so⁸.
- 2.12 The Myners Principles were reviewed in 2004 and 2007. Principle 5 now states that “trustees should adopt, or ensure that their investment managers adopt, the Institutional Shareholders’ Committee Statement of Principles on the responsibilities of shareholders and agents”. In 2008 the Investment Governance Group was created to provide joint government and industry ownership of the updated principles and guidance for trustees⁹.
- 2.13 In November 2007, the Walker Guidelines Monitoring Group¹⁰ was established to provide oversight on disclosure issues relating to "portfolio companies" that qualify for enhanced reporting and those private equity firms that own them. The Hedge Fund Standards Board¹¹ was also set up in 2007 to monitor conformity to best practice standards for the alternative investment fund industry.

⁵ Supporting Statement from Investment Consultants on the Institutional Shareholders’ Committee’s Statement of Principles on the Responsibilities of Institutional Shareholders and Agents: October 2005

⁶ Sections 1277-1280 of the Companies Act 2006:

http://www.opsi.gov.uk/acts/acts2006/ukpga_20060046_en_1

⁷ ISC 2007 framework on voting disclosure

<http://institutionalshareholderscommittee.org.uk/sitebuildercontent/sitebuilderfiles/ISCframeworkvotingdisclosurejun07.pdf>

⁸ Investment Management Association; Survey of Fund Managers’ Engagement with Companies for the two years ending 30 June 2008; May 2009

⁹ Investment Governance Group <http://www.thepensionsregulator.gov.uk/igg/>

¹⁰ Walker Guidelines Monitoring Group <http://www.walker-gmg.co.uk>

¹¹ Hedge Fund Standards Board <http://www.hfsb.org/>

2.14 In November 2009, HM Treasury's Asset Management Working Group published a report¹² on the UK as a global centre for asset management. This report included the recommendation that "engagement by shareholders is to be encouraged by both industry and regulator, recognising that it will always be ultimately for clients to determine their preferred investment style."

EU and international developments

2.15 In November 2009, the European Commission published a report by RiskMetrics¹³ on national "comply or explain" codes for listed companies. The report recommended that there should also be codes for investors, also at national rather than EU level. To date no decisions have been taken as to whether this recommendation will be accepted.

2.16 Some EU countries already place certain disclosure obligations on shareholders, for example Portugal, the Netherlands and France. Other countries have chosen to apply international standards instead - for example, the Danish Financial Supervisory Authority has recently required institutional investors to report against the UN Principles for Responsible Investment.

2.17 In the United States, the SEC set up an Investor Advisory Committee in June 2009. This Committee has a sub-committee on investors as owners, the terms of reference for which include addressing "the responsibilities of shareholders".

2.18 **The FRC would welcome any insights on lessons which may be learned from experience outside the UK.**

¹² Asset Management Working Group; Asset Management: the UK as a Global Centre; November 2009

¹³ RiskMetrics; Study on Monitoring and Enforcement practices in Corporate Governance in the Member States: September 2009

3 THE COVERAGE OF THE CODE

- 3.1 The investment chain is complex and terms such as institutional shareholders are often used interchangeably but with different meanings. The relationship between the owners of a company and the company itself is often an indirect one. Beneficial owners may include pension fund trustees, mutual and life assurance funds, who in turn represent individual pension fund beneficiaries, unit trust and other policyholders. The beneficial owners will usually agree fund mandates with their investment managers as to how their money will be invested and how their shares will be voted. The investment manager may use a proxy voting service provider to vote the shares held by the registered owner, often a nominee company owned and operated by a custodian. The custodian may then deal with a registrar, who will manage the share register on behalf of the company. The owners or their representatives may also make use of other agents such as investment consultants to advise them on the award of fund management mandates.
- 3.2 The introduction to the ISC Code states that, for the purposes of the Code, “the term ‘institutional investor’ includes institutional shareholders such as pension funds, insurance companies, and investment trusts and other collective investment vehicles and any agents appointed to act on their behalf”. Separately, Section E of the Combined Code was intended to apply to institutional shareholders and agents such as investment managers and voting services agencies.
- 3.3 In his report, Sir David Walker recommended that the FRC should encourage the adherence by institutional investors to best practice in stewardship of UK listed companies. The FRC shares the objective that a stewardship code should be adopted as the standard which institutional investors practising active engagement, and their agents should aspire to follow, and against which they should report.
- 3.4 Sir David also recommended that “the FSA should require institutions that are authorised to manage assets for others to disclose clearly on their websites or in other accessible form the nature of their commitment to the Stewardship Code or their alternative business model”. In its response to the Walker Report the FSA stated that, on conclusion of the FRC’s consultation on the Stewardship Code, it would consult upon a rule introducing a “comply or explain” requirement for relevant investment management firms. Such a rule would result in new mandatory requirements being imposed on UK investors.

- 3.5 Some investors are already subject to mandatory requirements under UK law. For example, pension funds are required under Section 244 of the Pensions Act 2004 to report to their beneficiaries on their management of the scheme's assets by publishing a Statement of Investment Principles, and to disclose their policy on engagement to scheme members either in that Statement or in their annual report.
- 3.6 **The FRC would encourage all UK institutional investors to apply and report on the Code regardless of whether or not they are subject to mandatory requirements, and would welcome views on whether there are any barriers or other reasons that would prevent or discourage them from doing so.**

Agents of institutional shareholders

- 3.7 The introduction to the ISC Code states that it is intended to cover the activities of both institutional shareholders "and those that invest as agents". Asset managers are not the only agents used by institutional shareholders. For example, proxy voting agencies offer research and voting services. Principle 1 of the ISC Code includes guidance which recommends that shareholders should disclose "the use made of, if any, proxy voting or other voting advisory services, including information on how they are used".
- 3.8 Many investors also employ investment consultants to analyse the services offered by asset managers, and they have in the past publicly supported the ISC Statement of Principles. Anecdotal evidence suggests that engagement has not been an area to which they have devoted much attention in the past, but that it has been increasing in recent years.
- 3.9 **Views are invited on whether agents such as voting services agencies and investment consultants should be encouraged to commit to the spirit of the Code, and, if so, how this could be done.**

Foreign investors

- 3.10 Foreign investors play an increasingly important role in the UK market. According to the most recent available statistics¹⁴ they owned 40% of UK shares in 2006 and the figure is likely to be higher now. Their ability to influence the UK companies in which they invest is potentially significant.

¹⁴ Office for National Statistics; Share Ownership: A report on ownership of UK shares as at 31 December 2006; 2007

- 3.11 The Walker Review recommended that foreign investors should be encouraged to commit to the Stewardship Code on a voluntary basis in the belief that “this is likely to be in their own interests and in that of their clients as ultimate beneficiaries”. In addition many of them, such as sovereign wealth funds and overseas pension funds, have a long-term perspective which is consistent with the underlying objective of the UK’s governance framework, which is to promote the long-term success of investee companies.
- 3.12 There is no intention that any mandatory requirements introduced for some or all UK institutional investors should apply to foreign investors, but the FRC would encourage such investors to engage actively and in a transparent manner with those UK companies in which they invest.
- 3.13 **The FRC is keen to hear from foreign investors in response to this consultation, and would in particular welcome comments on:**
- **Whether foreign investors would be willing voluntarily to commit to a Code sponsored by a UK regulator such as the FRC or a UK industry body like the ISC in respect of their holdings in UK companies;**
 - **Their current practice on disclosing information on their engagement policy, including any national or international standards they follow; and**
 - **Any barriers or other potential difficulties for foreign shareholders seeking to engage with UK companies.**
- 3.14 **The FRC would also be interested to hear from investors who operate on a cross-border basis about any potential conflicts which might arise between requirements or codes in place in other countries and the proposed Stewardship Code.**

4 THE CONTENT OF THE CODE

4.1 The FRC believes that using the ISC Code as the basis for the Stewardship Code will help to promote a sense of ownership among investors which will encourage wider adoption of the Code. The FRC therefore intends to accept oversight of the Code either in its existing or in amended form, subject to the outcome of this consultation.

4.2 The full text of the ISC Code is at Appendix B. **Respondents are welcome to comment on any aspect of the ISC Code, but in particular views are invited on these questions:**

- **What are the responsibilities for engagement of institutional shareholders to the beneficial owners whose interests they represent? Does the ISC Code cover all the relevant responsibilities?**
- **What are the responsibilities for engagement of institutional shareholders to the UK listed companies in which they invest? Does the ISC Code cover all the relevant responsibilities?**
- **Are the respective responsibilities of the different parts of the investment chain sufficiently clear and appropriate?**
- **Does the Code strike the right balance between the need to avoid over-specification that might discourage the application of the Code and the need for it to be effective with an appropriate degree of transparency?**
- **Are there any parts of the ISC Code where further guidance is needed, or where the existing guidance should be amended?**

Differences between the ISC Code and Section E of the Combined Code

4.3 The FRC stated in its December 2009 consultation on revisions to the Combined Code that it intended to remove Section E of that Code (which is addressed to institutional investors), subject to sufficient progress being made on the Stewardship Code.

4.4 A table comparing the ISC Code with Section E of the Combined Code is at Appendix C but the key differences are highlighted below. **Views are invited on whether the ISC Code adequately covers the content of Section E of the Combined Code.**

The basis for company/ shareholder dialogue

- 4.5 Section E of the Combined Code refers to a dialogue based on the mutual understanding of objectives, whereas the ISC Code refers to a dialogue to help improve long-term returns to shareholders, reduce the risk of catastrophic outcomes due to bad strategic decisions, and help with the efficient exercise of governance responsibilities.
- 4.6 The FRC considers that the ISC wording is probably clearer and in any event does not see this difference as a barrier to adopting the ISC Code.

Consideration of investee companies' explanations by shareholders

- 4.7 The Combined Code recommends that investors set out their reasons in writing where they do not accept explanations provided by the company, but the ISC Code does not. Nor is there any mention in the ISC Code of the need to bear in mind the size and complexity of the company concerned and the nature of the risks and challenges it faces in judging an explanation.
- 4.8 However the ISC Code does state that it is good practice to inform the company in advance of an intention to abstain or vote against a resolution, and to explain the reasons why. In addition, the proposed ISC guidance on disclosure of the investor's use of proxy voting services is aimed at providing greater transparency around one of the main complaints about box-ticking.

Attendance at AGMs

- 4.9 The provisions of Section E of the Combined Code state that "major shareholders should attend AGMs where appropriate and practicable", but there is no mention of attendance at AGMs in the ISC Code. Some respondents to the review of the Combined Code considered that this was unrealistic and impractical, as large institutional investors will hold shares in many hundreds of companies, and as a result attendance at AGMs by institutional as opposed to private shareholders was only likely in exceptional circumstances.

5 REPORTING, MONITORING AND REVIEW

5.1 This section of the consultation considers reporting by institutional shareholders applying the Stewardship Code. Reporting by institutional shareholders to their clients is of vital importance as it enables the latter to judge the extent to which their mandates are being met and managers are engaging with companies on their behalf. However the primary public policy interest is in the ISC Code's proposals for publicly available reporting to promote better understanding and communication between companies and investors and to assist the investment chain to operate more effectively. This will also facilitate better informed decisions by existing and prospective clients in awarding fund management mandates as recommended in the Walker Report. Experience with the Combined Code demonstrates that greater transparency also contributes to higher standards.

5.2 **The FRC would welcome views on:**

- **The information that institutional shareholders should make publicly available and that they should report to clients;**
- **The arrangements that should be put in place to monitor how institutional shareholders apply and report against the Code; and**
- **The arrangements for reviewing the operation and content of the Code.**

Publicly available reporting

5.3 **The FRC would welcome views on two issues: the specific information that should be disclosed by institutional shareholders and their agents, and at what level of detail the "comply or explain" principle should apply.**

Information to be disclosed

5.4 The ISC Code recommends that the following information should be made publicly available:

"Principle 1: Institutional investors should publicly disclose their policy on how they will discharge their stewardship responsibilities." The guidance recommends that the firm's policy should include:

- How investee companies will be monitored.

- The strategy on intervention.
- Internal arrangements, including how stewardship is integrated with the wider investment process.
- The policy on voting and the use made of, if any, proxy voting or other voting advisory services, including information on how they are used.
- The policy on considering explanations made in relation to the Combined 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.

Guidance to Principle 5: Institutional investors should disclose their policy on collective engagement.

Guidance to Principle 6: Institutional investors should disclose publicly voting records and if they do not, explain why.

Guidance to Principle 7: The existence of such assurance certification [AAF 01/06 and SAS 70] should be publicly disclosed.

5.5 The ISC Code contains no explicit recommendations on disclosure in relation to Principle 3 (“Institutional investors should monitor investee companies”) and Principle 4 (“Institutional investors should establish clear guidelines on when and how they will escalate their activities”).

5.6 **Views are invited on whether public disclosure of such information is appropriate and useful, and whether other information might also usefully be disclosed.**

“Comply or explain” requirement and the structure of the ISC Code

5.7 Under the Listing Rules, listed companies are required to report on how they have applied the principles of the Combined Code and whether they have complied with its detailed provisions and, where they have not, to provide an explanation. The ISC Code is also intended to be applied on a “comply or explain” basis.

- 5.8 The ISC Code consists of seven “principles” and provides further “guidance” on each of them, and states that institutional investors should state how they have applied the principles. This is a slightly different structure to that of the Combined Code which contains “principles” which listed companies must apply and “provisions” with which they must comply or explain under the FSA Listing Rules.
- 5.9 The ISC Code does not specify the manner in which “comply or explain” should operate. Possible ways in which investors might report against the Code might include:
- A statement as to whether the firm follows the Stewardship Code or an explanation of its alternative ownership or trading strategy if not.
 - A statement of how the firm has applied the principles within the Code, in a manner that would enable their clients to evaluate how the principles have been applied, with an explanation of non-compliance against each of the principles where applicable.
 - A statement as to whether the firm has complied with all the relevant principles and guidance within the Code or, where it has not, an explanation of non-compliance.
- 5.10 **Views are invited on the structure of the ISC Code and on the best way to encourage reporting against it on a “comply or explain” basis.**

Reporting to clients

- 5.11 Investment firms and other agents should report regularly to their clients on how they have discharged their responsibilities. Principle 7 of the ISC Code, which relates to reporting on stewardship and voting activities, states that “the particular information reported, including the format in which details of how votes have been cast are [to] be presented, should be a matter for agreement between agents and their principals”.
- 5.12 The ISC has also recommended that investors who sign up to its Code should obtain an independent opinion from an auditor on their engagement and voting processes and that the existence of such assurance reports should be publicly disclosed. The opinion would have regard to certain assurance reporting standards, which are explained in more detail in Appendix D.

- 5.13 The current standard does not cover fund managers' engagement policies and disclosures, but the guidance is to be reviewed and updated by the Institute of Chartered Accountants in England and Wales (ICAEW) during 2010 and this provides an opportunity for its scope to be extended.
- 5.14 **Views are invited on the proposals in ISC Code for reporting to clients and the merits of independent opinions from auditors or other professional accountants. It would be helpful to have estimates of the costs incurred by asset managers in commissioning these opinions and of the benefits to asset owners.**

Monitoring of publicly available reporting

- 5.15 There are potentially two types of monitoring envisaged in relation to publicly available disclosures made against the Stewardship Code: monitoring of the extent to which institutional investors overall are applying and reporting against the Code, and monitoring of whether individual investors subject to the proposed FSA "comply or explain" rule had complied with that requirement. This section seeks views on monitoring of the overall application of the Code.
- 5.16 In his report Sir David Walker recommended that "all fund managers that indicate commitment to engagement should participate in a survey to monitor adherence to the Stewardship Code. Arrangements should be put in place under the guidance of the FRC for appropriately independent oversight of this monitoring process."
- 5.17 One option would be for the FRC to undertake such a monitoring exercise itself. This is not something that the FRC currently does in respect of companies' adherence to the Combined Code, as it is able to rely on surveys undertaken by independent parties such as Grant Thornton and Deloitte. If the FRC is not to undertake such monitoring itself, it will need to be satisfied that sufficiently independent alternative arrangements are in place.

- 5.18 The Investment Management Association (IMA) currently carries out regular surveys of its members' engagement practices. To date there have been five surveys which have assessed investment managers' adherence to the original ISC Statement of Principles. The most recent survey¹⁵ covered 32 investment managers that together managed 68% of all UK equities. More details on the contents of the survey can be found in Appendix D.
- 5.19 If the IMA survey were to be used as the basis for monitoring overall application of the Stewardship Code there are some points that would need to be addressed. At present the survey covers only IMA members, with the result that some major institutional investors are not included. It also lacks the element of independent verification.
- 5.20 Other options might include recognising other existing mechanisms (for example, for those investors that are signatories to the United Nations Principles of Responsible Investment, the monitoring activities of the PRI Secretariat). Alternatively, the FRC and the investment industry might develop entirely new monitoring arrangements.
- 5.21 **Views are invited on the merits of the current IMA survey and other possible approaches to monitoring the overall application of the Code.**

Review

- 5.22 Subject to views expressed in response to this consultation, the FRC proposes to introduce a review process for the Stewardship Code equivalent to that already in place for the Combined Code: that is, reviews would in the normal course of events be undertaken every two or three years, would involve public consultation with those applying the Code and other interested parties, and would focus on the overall effectiveness of the Code and the "comply or explain" mechanism rather than its application by individual investors. **Views are invited on this proposed approach.**

¹⁵ Investment Management Association; Survey of Fund Managers' Engagement with Companies for the two years ending 30 June 2008; May 2009
<http://www.investmentfunds.org.uk/press/2009/20090520-2-01.pdf>

ISSUES FOR COMMENT

Section 1: Introduction

The FRC would welcome views on the policy objectives against which the FRC should judge its approach to a Stewardship Code (paragraph 1.14), the proposed objectives being to:

- Set standards of stewardship to which mainstream institutional investors should aspire, and maintain the credibility and quality of these standards through independent input on the content and monitoring of the Code;
- Promote a sense of ownership of the Code amongst institutional investors in order to encourage UK and foreign shareholders to apply and report against it;
- Ensure that engagement is closely linked to the investment process within the investment firm;
- Contribute towards improved communication between shareholders and the boards of the companies in which they invest; and
- Secure sufficient disclosure to enable institutional shareholders' prospective clients to assess how those managers are acting in relation to the Code so that this can be taken into account when awarding and monitoring fund management mandates.

The FRC is seeking views on whether it should accept oversight of the Code in its current form, or whether amendments should be made before the FRC does so (paragraph 1.16).

Views are also sought on which institutional investors and agents should be encouraged to apply the code on a "comply or explain" basis, what they should be asked to disclose and to whom, and the monitoring arrangements that should be put in place (paragraph 1.17).

Section 2: Background and Recent Developments

The FRC would welcome any insights on lessons which may be learned from experience outside the UK (paragraph 2.18).

Section 3: The Coverage of the Code

The FRC would encourage all UK institutional investors to apply and report on the Code regardless of whether or not they are subject to mandatory requirements, and would welcome views on whether there are any barriers or other reasons that would prevent or discourage them from doing so (paragraph 3.6).

Views are invited on whether agents such as voting services agencies and investment consultants should be encouraged to commit to the spirit of the Code, and if so how this could be done (paragraph 3.8).

The FRC is keen to hear from foreign investors in response to this consultation, and would in particular welcome comments on:

- Whether foreign investors would be willing voluntarily to commit to a Code sponsored by a UK regulator such as the FRC or a UK industry body like the ISC in respect of their holdings in UK companies;
- Their current practice on disclosing information on their engagement policy, including any national or international standards they follow; and
- Any barriers or other potential difficulties for foreign shareholders seeking to engage with UK companies (paragraph 3.13).

The FRC would also be interested to hear from investors who operate on a cross-border basis about any potential conflicts which might arise between requirements or codes in place in other countries and the proposed Stewardship Code (paragraph 3.14).

Section 4: The Content of the Code

Respondents are welcome to comment on any aspect of the ISC Code, but in particular views are invited on these questions:

- What are the responsibilities for engagement of institutional investors to the beneficial owners whose interests they represent? Does the ISC Code cover all the relevant responsibilities?
- What are the responsibilities for engagement of institutional shareholders to the UK listed companies in which they invest? Does the ISC Code cover all the relevant responsibilities?
- Are the respective responsibilities of the different parts of the investment chain sufficiently clear and appropriate?
- Does the Code strike the right balance between the need to avoid over-specification that might discourage the application of the Code and the need for it to be effective with an appropriate degree of transparency?
- Are there any parts of the ISC Code where further guidance is needed, or where the existing guidance should be amended? (paragraph 4.2)

Views are invited on whether the ISC Code adequately covers the content of Section E of the Combined Code (paragraph 4.4)

Section 5: Reporting, Monitoring and Review

The FRC would welcome views on:

- The information that institutional shareholders should disclose publicly and that they should report to clients;
- The arrangements that should be put in place to monitor how institutional shareholders apply and report against the Code; and
- The arrangements for reviewing the operation and content of the Code (paragraph 5.2).

The FRC would welcome views on the specific information that should be disclosed by institutional shareholders and their agents, and at what level of detail the “comply or explain” principle should apply (paragraph 5.3).

Views are invited on whether public disclosure of the information summarised is appropriate and useful, and whether other information might also usefully be disclosed (paragraph 5.6).

Views are invited on the structure of the ISC Code and on the best way to encourage reporting against it on a “comply or explain” basis (paragraph 5.10).

Views are invited on the proposals in ISC Code for reporting to clients and the merits of independent opinions from auditors or other professional accountants. It would be helpful to have estimates of the costs incurred by asset managers in commissioning these opinions and of the benefits to asset owners (paragraph 5.14).

Views are invited on the merits of the current IMA survey and other possible approaches to monitoring the overall application of the Code (paragraph 5.21).

Views are invited on the proposed approach to reviewing the Code (paragraph 5.22).

APPENDIX B

INSTITUTIONAL SHAREHOLDERS' COMMITTEE CODE ON THE RESPONSIBILITIES OF INSTITUTIONAL INVESTORS

Introduction & Scope

This Code has been drawn up by the Institutional Shareholders' Committee¹⁶ and covers the activities of both institutional shareholders and those that invest as agents, including reporting by the latter to their clients.

The Code aims to enhance the quality of the dialogue of institutional investors with companies to help improve long-term returns to shareholders, reduce the risk of catastrophic outcomes due to bad strategic decisions, and help with the efficient exercise of governance responsibilities.

The Code sets out best practice for institutional investors that choose to engage with the companies in which they invest. The Code does not constitute an obligation to micro-manage the affairs of investee companies or preclude a decision to sell a holding, where this is considered the most effective response to concerns.

In the Code the term "institutional investor" includes institutional shareholders such as pension funds, insurance companies, and investment trusts and other collective investment vehicles and any agents appointed to act on their behalf.

Institutional shareholders' mandates given to fund managers or agents should specify the policy on stewardship, if any, that is to be followed.

Institutional shareholders are free to choose whether or not to engage but their choice should be a considered one, based on their investment objectives. Their managers or agents are then responsible for ensuring that they comply with the terms of the mandate as agreed¹⁷.

The Code applies to institutional investors on a comply-or-explain basis. Institutional investors that do not wish to engage should state publicly that the Code is not relevant to them and explain why.

¹⁶ ISC members are: the Association of British Insurers, the Association of Investment Companies, the National Association of Pension Funds and the Investment Management Association.

¹⁷ In the case of pension funds, best practice is set out in the 2008 Myners' Principles under Principle 5: Trustees should adopt, or ensure that their investment managers adopt, the Institutional Shareholders' Committee Statement of Principles on the responsibilities of shareholders and agents. A statement of the scheme's policy on responsible ownership should be included in the Statement of Investment Principles. Trustees should report periodically to members on the discharge of such responsibilities.

Institutional investors that elect to engage should provide a statement on how they implement the Principles in practice. Institutional investors that apply the Code will be listed on the ISC's website. This statement should contain information on what steps have been or will be taken in respect of verification.

Fulfilling fiduciary obligations to end-beneficiaries in accordance with the spirit of the Code may have implications for institutional investors' resources. These should be sufficient to allow them to fulfil their responsibilities effectively, commensurate with the benefits derived. The duty of institutional investors is to their end-beneficiaries and/or clients and not to the wider public.

The Code may also be applied by overseas investors, including Sovereign Wealth Funds. The ISC would welcome their commitment to the Code and may also list those that choose to sign up on the ISC's website. The Code will be reviewed biennially by the ISC in line with the FRC's review process for the Combined Code.

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

Guidance

The policy should include:

- How investee companies will be monitored. In order for monitoring to be effective, where necessary, an active dialogue may need to be entered into with the investee company's board.
- The strategy on intervention.
- Internal arrangements, including how stewardship is integrated with the wider investment process.
- The policy on voting and the use made of, if any, proxy voting or other voting advisory service, including information on how they are used (see Principle 6).
- The policy on considering explanations made in relation to the Combined 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.

Guidance

An institutional investor's duty is to act in the interests of all clients and/or beneficiaries when considering matters such as engagement and voting.

Conflicts of interest will inevitably arise from time to time, which may include when voting on matters affecting a parent company or client.

Institutional investors should put in place and maintain a policy for managing conflicts of interest.

Principle 3: Institutional investors should monitor their investee companies

Guidance

Investee companies should be monitored to determine when it is necessary to enter into an active dialogue with their boards. This monitoring should be regular, and the process clearly communicable and checked periodically for its effectiveness.

As part of this monitoring, institutional investors should:

- seek to satisfy themselves, to the extent possible, that the investee company's board and sub-committee structures are effective, and that independent directors provide adequate oversight; and
- maintain a clear audit trail, for example, records of private meetings held with companies, of votes cast, and of reasons for voting against the investee company's management, for abstaining, or for voting with management in a contentious situation.

Institutional investors should endeavour to identify problems at an early stage to minimise any loss of shareholder value. If they have concerns they should seek to ensure that the appropriate members of the investee company's board are made aware of them.

Institutional investors may not wish to be made insiders. They will expect investee companies and their advisers to ensure that information that could affect their ability to deal in the shares of the company concerned is not conveyed to them without their agreement.

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

Guidance

Institutional investors should set out the circumstances when they will actively intervene and regularly assess the outcomes of doing so. Intervention should be considered regardless of whether an active or passive investment policy is followed. In addition, being underweight is not, of itself, a reason for not intervening. Instances when institutional investors may want to intervene include when they have concerns about the company's strategy and performance, its governance or its approach to the risks arising from social and environmental matters.

Initial discussions should take place on a confidential basis. However, if boards do not respond constructively when institutional investors intervene, then institutional investors will consider whether to escalate their action, for example, by:

- holding additional meetings with management specifically to discuss concerns;
- expressing concerns through the company's advisers;
- meeting with the Chairman, senior independent director, or with all independent directors;
- intervening jointly with other institutions on particular issues;
- making a public statement in advance of the AGM or an EGM;
- submitting resolutions at shareholders' meetings; and
- requisitioning an EGM, possibly to change the board.

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

Guidance

At times collaboration with other investors may be the most effective manner in which to engage.

Collaborative engagement may be most appropriate at times of significant corporate or wider economic stress, or when the risks posed threaten the ability of the company to continue.

Institutional investors should disclose their policy on collective engagement.

Institutional investors when participating in collective engagement should have due regard to their policies on conflicts of interest and insider information.

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

Guidance

Institutional investors should seek to vote all shares held. They should not automatically support the board.

If they have been unable to reach a satisfactory outcome through active dialogue then they should register an abstention or vote against the resolution. In both instances, it is good practice to inform the company in advance of their intention and the reasons why.

Institutional investors should disclose publicly voting records and if they do not explain why.

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

Guidance

Those that act as agents should regularly report to their clients details on how they have discharged their responsibilities. Such reports will be likely to comprise both qualitative as well as quantitative information. The particular information reported, including the format in which details of how votes have been cast are be presented, should be a matter for agreement between agents and their principals.

Transparency is an important feature of effective stewardship. Institutional investors should not, however, be expected to make disclosures that might be counterproductive. Confidentiality in specific situations may well be crucial to achieving a positive outcome.

Those that act as principals, or represent the interests of the end-investor, should report at least annually to those to whom they are accountable on their policy and its execution.

Those that sign up to this Code should consider obtaining an independent audit opinion on their engagement and voting processes having regard to the standards in AAF 01/063¹⁸ and SAS 70¹⁹. The existence of such assurance certification should be publicly disclosed.

¹⁸ Assurance reports on internal controls of service organisations made available to third parties

¹⁹ Statement on Auditing Standards No.70: Reports on the processing of transactions by service organizations

COMPARISON OF SECTION E OF THE COMBINED CODE AND THE ISC CODE

Combined Code	ISC Code
<p>E.1 Dialogue with Companies</p> <p>Main Principle: Institutional shareholders should enter into a dialogue with companies based on the mutual understanding of objectives.</p>	<p>Introduction: The Code aims to enhance the quality of the dialogue of institutional investors with companies to help improve long-term returns to shareholders, reduce the risk of catastrophic outcomes due to bad strategic decisions, and help with the efficient exercise of governance responsibilities.</p> <p>Guidance to Principle 1: In order for monitoring to be effective, an active dialogue may need to be entered into with the investee company's board.</p>
<p>Supporting Principle: Institutional shareholders should apply the principles set out in the ISC's Statement of Principles, which should be reflected in fund manager contracts.</p>	<p>Introduction: Institutional shareholders' mandates given to fund managers or agents should specify the policy on stewardship, if any, that is to be followed. Institutional shareholders are free to choose whether or not to engage but their choice should be a considered one, based on their investment objectives. Their managers or agents are then responsible for ensuring that they comply with the terms of the mandate as agreed.</p>

<p>E.2 Evaluation of Governance Disclosures</p> <p>Main Principle: When evaluating companies' governance arrangements particularly those relating to board structure and composition, institutional shareholders should give due weight to all relevant factors drawn to their attention.</p>	<p>Principle 3: Institutional investors should monitor their investee companies.</p> <p>Guidance: Investee companies should be monitored to determine when it is necessary to enter into an active dialogue with their boards.... Institutional investors should seek to satisfy themselves, to the extent possible, that the investee company's board and sub-committee structures are effective, and that independent directors provide adequate oversight.</p>
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<p>Supporting Principle: Institutional shareholders should consider carefully explanations given for departure from this Code and make reasoned judgements in each case. They should give an explanation to the company, in writing where appropriate, and be prepared to enter a dialogue if they do not accept the company's position. They should avoid a box-ticking approach to assessing a company's corporate governance. They should bear in mind in particular the size and complexity of the company and the nature of the risks and challenges it faces.</p>	<p>Guidance to Principle 1: [Institutional investors should publicly disclose:]</p> <p>The policy on voting and the use made of, if any, proxy voting or other voting advisory service, including information on how they are used (see Principle 6).</p> <p>The policy on considering explanations made in relation to the Combined Code.</p> <p>Guidance to Principle 3: Institutional investors should endeavour to identify problems at an early stage to minimise any loss of shareholder value. If they have concerns they should seek to ensure that the appropriate members of the investee company's board are made aware of them.</p> <p>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.</p> <p>Guidance to Principle 4: Initial discussions should take place on a confidential basis.</p> <p>Guidance to Principle 6: In both instances [abstention or vote again], it is good practice to inform the company in advance of their intention and the reasons why.</p>
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<p>E.3 Shareholder Voting</p> <p>Main Principle: Institutional shareholders have a responsibility to make considered use of their votes.</p>	<p>Principle 6: Institutional investors should have a clear policy on voting and disclosure of voting activity.</p> <p>Guidance to Principle 6: Institutional shareholders should seek to vote all shares held. They should not automatically support the board. If they have been unable to reach a satisfactory outcome through active dialogue then they should register an abstention of vote against the resolution. In both instances, it is good practice to inform the company in advance of their intention and the reasons why.</p>
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<p>Supporting Principles: Institutional shareholders should take steps to ensure their voting intentions are being translated into practice.</p> <p>Institutional shareholders should, on request, make available to their clients information on the proportion of resolutions on which votes were cast and non-discretionary proxies lodged.</p> <p>Major shareholders should attend AGMs where appropriate and practicable. Companies and registrars should facilitate this.</p>	<p>Guidance to Principle 7: Those that sign up to this Code should consider obtaining an independent audit opinion on their engagement and voting processes having regard to the standards in AAF 01/06 and SAS 70. The existence of such assurance certification should be publicly disclosed.</p> <p>Principle 7: Institutional investors should report periodically on their stewardship and voting activities.</p> <p>Guidance to Principle 7: Those that act as principals, or represent the interests of the end-investor, should report at least annually to those to whom they are accountable on their policy and its execution.</p> <p>Guidance to Principle 4: ...institutional investors will consider whether to escalate their action e.g. by:</p> <ul style="list-style-type: none"> • making a public statement in advance of the AGM or EGM; • submitting resolutions at shareholders' meetings; and • requisitioning an EGM, possibly to change the board.
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APPENDIX D

REPORTING AND MONITORING

Reporting to clients: assurance engagement reporting

Principle 7 of the ISC Code (which relates to reporting on stewardship and voting activities) states that “the particular information reported, including the format in which details of how votes have been cast are [to] be presented, should be a matter for agreement between agents and their principals”.

The ISC has also recommended that investors that sign up to its Code should obtain an independent opinion from an auditor on their engagement and voting processes, and that the existence of such assurance reporting should be publicly disclosed.

The most relevant existing standard is AAF 01/06, which is produced by the Audit and Assurance Faculty of the Institute of Chartered Accountants in England & Wales (ICAEW). The AAF is based on the International Federation of Accountants Committee's International Standard of Assurance Engagements (ISAE) 3000. The ICAEW is currently upgrading the AAF to include the more recent ISAE 3402 and accompanying guidance for service providers, and intends to issue the amended AAF later in 2010.

The main elements of AAF 01/06 are:

- It requires a qualitative judgement on what the service providers to a fund have done;
- It contains a “reasonable assurance” report;
- The auditors or professional accountants will have access to appropriate information including contracts and review controls over, inter alia, custody, investment management, pension administration, property management, fund accounting and transfer agency.
- The control objectives for investment management may cover a variety of issues, including:
 - whether accounts are set up and administered in accordance with client agreements and applicable regulations;
 - whether responsibility for generating proxy voting instructions is clearly established; and
 - whether corporate actions and voting instructions are identified, processed and recorded on a timely basis.

The guidance under Principle 7 of the ISC Code also refers to the US standard SAS 70. SAS 70 and ISAE 3402 are being aligned but there is an important difference in that the AAF specifies detailed control objectives whilst SAS 70 does not. Therefore the AAF provides a more objective basis for reporting by service providers and auditors or other professional accountants. In practice, however, a number of SAS 70 reports are based on the AAF control objectives to overcome this issue.

External monitoring: the Investment Management Association survey

The Investment Management Association (IMA) currently carries out regular surveys of its members' engagement practices. To date there have been five surveys which have assessed investment managers' adherence to the original ISC Statement of Principles. The most recent survey²⁰ covered 32 investment managers that together managed 68% of all UK equities.

The scope of each survey is agreed by a pilot group consisting of fund managers, with input from HM Treasury and the TUC. Representatives from 32 firms are then interviewed by the IMA and substantive details of engagement activities obtained through the completion of a questionnaire. Once the results are collated, a final draft of the report is sent to all participants for comment before publication.

The survey addresses whether participants:

- publish a policy statement on engagement;
- monitor and maintain a dialogue with companies;
- intervene where necessary and vote their shares;
- evaluate the impact of their policies;
- publish voting details
- refer to engagement policies in client agreements;
- have governance resources in place;
- integrate engagement into the investment process;
- have discretion to issue all voting instructions and the timing of such instructions;
- have a policy on stock lending; and
- report to clients.

²⁰ IMA Survey of Fund Managers' Engagement with Companies for the two years ending 30 June 2008
<http://www.investmentfunds.org.uk/press/2009/20090520-2-01.pdf>



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