



**FINANCIAL REPORTING COUNCIL**

**THE UK STEWARDSHIP CODE**

**JULY 2010**

# PREFACE

The Stewardship Code 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. Engagement includes pursuing purposeful dialogue on strategy, performance and the management of risk, as well as on issues that are the immediate subject of votes at general meetings.

The Code sets out good practice on engagement with investee companies to which the FRC believes institutional investors should aspire. It provides an opportunity to build a critical mass of UK and overseas investors committed to the high quality dialogue with companies needed to underpin good governance. By creating a sound basis of engagement it should create a much needed stronger link between governance and the investment process, and lend greater substance to the concept of “comply or explain” as applied by listed companies. The FRC therefore sees it as complementary to the UK Corporate Governance Code for listed companies, as revised in June 2010.

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

Disclosures made by institutions under the Code should assist companies to understand the approach and expectations of their major shareholders. They should also assist those issuing mandates to institutional fund managers to make a better informed choice, thereby improving the functioning of the market and facilitating the exercise of responsibility to end-investors.

As with the UK Corporate Governance Code, the Code should be applied on a “comply or explain” basis. In reporting terms this entails providing a statement on the institution’s website that contains:

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

It should be noted that compliance with the Code does not constitute an invitation to manage the affairs of investee companies or preclude a decision to sell a holding, where this is considered in the best interest of end-investors.

The Code is addressed in the first instance to firms who manage assets on behalf of institutional shareholders such as pension funds, insurance companies, investment trusts and other collective investment vehicles. The FRC expects those firms to disclose on their websites how they have applied the Code. Institutions that manage several types of fund need to make only one statement.

However the responsibility for monitoring company performance does not rest with fund managers alone. Pension fund trustees and other owners can do so either directly or indirectly through the mandates given to fund managers. Their actions can have a significant impact on the quality and quantity of engagement with UK companies. The FRC therefore strongly encourages all institutional investors to report if and how they have complied with the Code.

Principle 1 of the Code states that institutional investors that make use of proxy voting and other advisory services should disclose how they are used. The FRC encourages those service providers in turn to disclose how they carry out the wishes of their clients by applying the principles of the Code that are relevant to their activities.

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

Specifically, the “explain” option means that overseas investors who follow other national or international standards that have similar objectives should not feel application of the Code duplicates or confuses their responsibilities. Disclosures made in respect of those standards can also be used to demonstrate the extent to which they have complied with the Code. In a similar spirit, UK institutions that apply the Code should use their best efforts to apply its principles to overseas holdings.

The FRC will retain on its website a list of those investors that have published a statement on their compliance or otherwise with the Code, and requests that they notify the FRC when they have done so. The FRC also considers that it would be good practice for each institution to name in its statement an individual who can be contacted for further information and by those interested in collective engagement.

The FRC will carry out regular monitoring of the take-up and application of the Code.

The FRC expects the content of the Code to evolve over time to reflect developments in good engagement practice, in the structure and operation of the market, and the broader regulatory framework, and it will need to give further consideration to issues raised in response to the consultation on this Code in the same light. A decision on the timing of the first review of the content of the Code will be taken in the second half of 2011.

Financial Reporting Council  
July 2010

# THE PRINCIPLES OF THE CODE

Institutional investors should:

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

# THE UK STEWARDSHIP CODE

## Principle 1

**Institutional investors should publicly disclose their policy on how they will discharge their stewardship responsibilities.**

### Guidance

The disclosure should include:

- how investee companies will be monitored. In order for monitoring to be effective an active dialogue may, where necessary, 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; and
- the policy on considering explanations made in relation to the UK Corporate Governance 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 committee structures are effective, and that independent directors provide adequate oversight, including by meeting the chairman and, where appropriate, other board members;
- 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; and
- attend the General Meetings of companies in which they have a major holding, where appropriate and practicable.

Institutional investors should consider carefully explanations given for departure from the UK Corporate Governance Code and make reasoned judgements in each case. They should give a timely explanation to the company, in writing where appropriate, and be prepared to enter a dialogue if they do not accept the company's position.

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, in some cases proposing to change board membership.

## **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.

When participating in collective engagement, institutional investors 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 of how they have discharged their responsibilities. Such reports will be likely to comprise qualitative as well as quantitative information. The particular information reported, including the format in which details of how votes have been cast are 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 01/06<sup>1</sup> and SAS 70<sup>2</sup>. The existence of such assurance certification should be publicly disclosed.

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<sup>1</sup> Assurance reports on internal controls of service organisations made available to third parties.

<sup>2</sup> Statement on Auditing Standards No.70: Reports on the processing of transactions by service organizations.





**FINANCIAL REPORTING COUNCIL**

**5TH FLOOR**

**ALDWYCH HOUSE**

**71-91 ALDWYCH**

**LONDON WC2B 4HN**

**TEL: +44 (0)20 7492 2300**

**FAX: +44 (0)20 7492 2301**

**WEBSITE: [www.frc.org.uk](http://www.frc.org.uk)**

ISBN 978-1-84798-335-0



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UP/FRC-BI10008

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