Investment Funds Alert
Institutional Investors, Long-Term Share Ownership and the U.K. Stewardship Code

July 9, 2010

BACKGROUND

The issue of shareholder oversight over publicly listed companies has long proved to be contentious. Even during the long bull run up until 2008, many commentators and market participants voiced frustration at the lack of active involvement by institutional investors in the ongoing affairs of their portfolio companies. The financial crisis of 2008 brought the issue to a head, with former City minister Lord Myners controversially describing institutional investors of behaving like “absentee landlords” and accusing the fund management industry of being asleep at the wheel in the lead up to the banking crisis. The tenet of this argument is that institutional investors have a wider responsibility than just being passive investors (according to Lord Myners, they acted as “leasehold investors” not “freehold owners”). Accordingly, such investors should acknowledge their responsibility to the wider market and society as a whole.

In his report, published in November 2009, on the governance of banks and other financial institutions, Sir David Walker implicitly criticized institutional investors for their role (or lack of) in the financial crisis. He, therefore, recommended that the Financial Reporting Council (FRC)—an independent regulator responsible for the promotion of corporate governance in the U.K., most notably the Combined Code—should extend its remit to cover the development of best practices in the ownership of U.K.-listed companies. Following consultation, the first Stewardship Code (the “Code”) was published on July 2, 2010.

OVERVIEW

Who Should Apply the Code – The Code is addressed to regulated firms that manage assets on behalf of institutional investors (such as pension funds, insurance companies, investment trusts and other collective investment vehicles). However, the Code also targets the institutional investors themselves, encouraging them to report if and how they have complied. 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, and these agencies, in turn, are encouraged to act in a way that is consistent with the Code, as well as 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 encourages investors based outside of the U.K. to engage with the Code. In particular, the FRC notes that non-U.K. investors who follow differing national or international standards “should not feel application of the Code duplicates or confuses their responsibilities.” The FRC hopes that the “explain” option (see below) would assist such investors in clarifying their own circumstances, thereby allowing the investor to comply with the Code as a whole.

How It Takes Effect – The Code will be applied on a voluntary “comply or explain” basis. The FRC is asking firms to disclose how they have applied the Code (a “Disclosure”). It is envisaged that disclosure will take place on each firm’s Web site.
A Disclosure is envisaged as a statement containing—

- 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 (see below); or
- an explanation, if these elements of the Code have not been complied with.

The FRC is asking all institutional investors and asset managers to publish their Disclosure by the end of September 2010 and to notify the FRC when they have done so. From October 2010, the FRC will list on its Web site all Disclosures that have been notified to it. The FRC will provide a link to the Disclosures, but will not comment on their contents.

The Scope of the Code – The FRC has based the Code upon the code on the responsibilities of institutional investors issued by the Institutional Shareholders Committee (ISC) in November 2009.

The most significant amendment is, specifically, the guidance on Principle 3 (on the monitoring of companies), which has been amended to encourage institutional investors and asset managers to—

- meet the chairman of investee companies, and other board members where appropriate, as part of their ongoing monitoring and not only when they have concerns
- attend the general meetings of companies in which they have a major holding, where appropriate and practicable
- consider carefully explanations given by investee companies for departure from the U.K. Corporate Governance Code and advise the company where they do not accept its position.

U.K. institutions that apply the Code should use their best efforts to apply its principles to overseas holdings.

The Principles –The seven Principles of the Code are that institutional investors and asset managers 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 to determine when active dialogue with boards should be entered into
- 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.

Additional detailed information on each of the Principles is included in the Code.

FUTURE DEVELOPMENTS

The U.K. Financial Services Authority will shortly begin consultation on proposals to introduce a mandatory requirement for authorized asset managers to disclose whether or not they comply with the Code. We will monitor and report on the FSA’s progress in this regard.

In June 2010, the European Commission published a Green Paper on corporate governance in financial institutions in which it indicated that it is considering possible EU-level action on the use of stewardship codes. The Commission also indicated that it would shortly be initiating a review of corporate governance in listed companies that might be expected to raise similar issues, with a Green Paper to follow in early 2011.
The ISC announced in May 2010 that it intended to establish a new senior body, the Institutional Investor Council, to build a single voice for the institutional investor community and strengthen its profile. The objectives of the new senior body will include working with the FRC in promoting the Code.

The FRC will begin full annual monitoring of the take-up and application of the Code in the second half of 2011.

**ANALYSIS**

The Code is another milestone in the root and branch overhaul of the investment management industry in the EU and beyond. Indeed, it was published the same week as draft amendments to the Capital Requirements Directive (dealing with investment firms’ remuneration practices) and comes hot on the heels of the draft financial services reform legislation in the United States and a week after the postponement of the adoption of the Alternative Investment Fund Managers Directive in the EU.

Much of the Code could be said to be benign and nothing more than a codification of best practices. And yet, the seemingly endless supply of regulatory standards, codes and best practices, along with changes to investment management law and regulation, can only be said to add to the compliance burden for investment managers.

In addition, the Code was also published with some haste, following a short consultation period, with a view to keeping the “momentum” for change in governance going. This has led to some acknowledged gaps in the Code, with the FRC stating that it would consult further on such areas as investors’ policies on stock lending and the nature of voting information disclosure.

The guidance on Principle 7 of the Code recommends that asset managers consider obtaining an independent audit opinion of their engagement and voting processes. Concerns have been expressed that this might lead to costly verification exercises. Guidance on this is currently being drafted, and the FRC accepts that some may wish to wait for this guidance to be published before adopting the Code. Non-retail managers may also wish to consider the outcome of the FSA consultation before committing to the Code in full.

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