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## New Guidelines for Institutional Investors

### Introduction

Institutional investors have been criticised, especially since the financial crisis, for failing to take a more active role in the governance of the companies that they invest in. In response to these criticisms, the Financial Reporting Council (the "FRC") issued the UK Stewardship Code (the "Code") at the beginning of July 2010. The Code is a new set of guidelines that outlines best practice for institutional investors on how they should engage with investee companies. It is designed to sit alongside the revised UK Corporate Governance Code that the FRC issued in May 2010.

### The Code

The Code is aimed primarily at firms that manage assets on behalf of institutional shareholders, although the FRC also encourages institutional investors themselves and service providers that they use (such as proxy voting agencies) to comply with the Code.

The Code contains seven key principles that 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 should publicly disclose this policy;

- 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; and
- report periodically on their stewardship and voting activities.

The principles are based on the existing statement of principles developed by the Institutional Shareholders' Committee ("ISC") in November 2009. However, firms are additionally encouraged to:

- meet the chairman of investee companies;
- attend general meetings of companies in which they have a major holding; and
- carefully consider explanations given by investee companies for their non-compliance with corporate governance regulations.

## Criticisms

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Although in its infancy, the Code has already generated significant debate.

Compliance with the Code is required on a “comply or explain” basis and institutions are expected to provide a statement on their websites containing details of how they have applied the Code, disclosing certain specified information and explaining those elements of the Code that they have not complied with. There is concern that the lack of any formal sanctions for failing to comply with the Code will mean that few institutions will do so. On the other hand, some commentators have argued that forcing institutions to comply with the Code would risk driving overseas investors away from the UK equity market.

There have also been concerns that the Code fails to go much beyond the existing guidance for institutional investors that was issued by the ISC in late 2009. For example, the Code does not include guidance on investors’ policies on stock lending, arrangements for voting pooled funds or the nature of voting information disclosure.

The cost of compliance with the Code, and who is willing to bear such cost, is also likely to affect the extent of compliance with the Code. Fund managers may not want to incur the extra costs of compliance unless their clients either agree to accept such costs or put significant pressure upon them to do so.

The Code was published quickly, in order to “keep the momentum going on governance”. The FRC has already acknowledged that the Code requires some further development and it is looking to introduce further obligations next year. This hasty approach, and failure to address certain issues, has been yet a further reason for criticism.

## Future Developments

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There are likely to be further changes to the Code in the near future; the FRC is due to review the Code in 2011. In addition, the ISC intends to establish the Institutional Investor Council, an organisation designed to provide a forum for the institutional investor community to voice their concerns, promote the Code and examine day-to-day issues. The Financial Services Authority is also considering whether to extend the “comply or explain” approach of the

FRC to a mandatory obligation on authorised asset managers to do so.

From a European perspective, the EU Commission published a green paper on corporate governance in financial institutions in June 2010, setting out details of their intention to introduce EU-level regulations governing the use of stewardship codes. This may have a further impact on the Code.

## Conclusion

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The Code has received much criticism and the FRC itself admits that further changes will be required, both to address issues that it has not yet dealt with and as a result of changes in governance and regulation that may be introduced independently by the ISC, the Financial Services Authority and the EU Commission.

The key test of the Code’s success, however, will be the number of institutions that do in fact “comply or explain”. The FRC has encouraged institutional investors to publish on their websites, by September 2010, a statement of the extent to which they have complied with the Code. The extent to which they do so will be the first real indicator of the Code’s success.

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