A "Stewardship Code" for Institutional Investors

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The role of shareholders in corporate governance has become one of the hot-button issues following the credit melt-down and economic crisis. Would more active involvement by shareholders have helped to prevent or lessen the crisis?

Broadly speaking, there are those who believe that short-term institutional shareholders — with concern about making their own quarterly or annual numbers, with opaque governance and improper incentives for fund-managers — are part of the problem, and that they have been one of the causes of short-sighted, risk-indifferent behavior by financial institutions.

On the other hand, there are those who believe that longer-term institutional shareholders are part of the solution — that increased shareholder involvement in governance, not just through exercise of market power, is essential to creation of sustainable, long-term corporate value, and to holding boards of directors and senior business leaders accountable. Such shareholder proponents advocate regulation or voluntary corporate action on key issues like "say on pay" or "proxy access."

A "third way" emerged late last year in the UK — a "Stewardship Code" for institutional investors.

While not fully developed, it is an interesting and potentially controversial approach which puts new responsibilities on the investor and investee communities. But amidst the UK furor over the government's decision to impose a 50% "super-tax" on bonuses over £25,000 in the financial sector, it has not received the attention it deserves.

The idea has its origins in an earlier code entitled "Responsibilities of Institutional Investors," issued in the fall of 2009 by the UK's Institutional Shareholders' Committee (a private organization comprised of insurance, pension, trust and management organizations). Shortly thereafter, former Morgan Stanley International chairman Sir David Walker, acting under direction from the Prime Minister, issued his final report on corporate governance in UK banks. He advocated that the Institutional Shareholders' Committee code be renamed the "Stewardship Code" and be adopted by the Financial Reporting Council, a quasi-regulatory entity which oversees the Combined Code on Corporate Governance affecting investee companies.

Walker's goal was that the code would apply to institutional investor relations with all corporations, not just financial institutions. The FRC agreed to develop a final code, subject to "separate consultation to ensure that it operated effectively."

In its current form, the code requires institutional investors to commit to the following general propositions:

- publicly disclose their policies on how they will discharge stewardship responsibilities (e.g. how they will monitor companies; how monitoring affects investment decisions).
- actively monitor investee companies.
- establish guidelines regarding when they will actively intervene with the company to "protect and enhance" shareholder value. This concept envisions both private discussions but, if necessary, escalating public actions from statements to resolutions to requests for board changes.
- act collectively with other investors where appropriate (and disclose policy on when such collective action is warranted).
- report periodically on their stewardship and voting activities.

The stated purpose of the code is to "enhance the quality of the dialogue" with companies, "reduce the risk of catastrophic outcomes," and aid "efficient exercise of governance responsibilities." Although the code sets out a "best practice" for investors that choose to engage with investee companies, the Institutional Shareholders Committee made clear: it "does not constitute an obligation to micro-manage...or preclude a decision to sell a holding where this is considered the most effective response to concerns."

At this point, it appears that adherence to the Stewardship Code will be voluntary under the UK concept, used in the combined governance code, of "comply or explain." Institutional investors will either sign up to comply with the code (and be listed as doing so on their websites and the websites of the shareholders' committee or the FRC), or explain why their business model precludes adherence to the code.

With Financial Reporting Council consultation, promulgation and implementation still in the future, there are, of course, numerous questions surrounding the Stewardship Code. For example:

–Why does the code not require important institutional investor information on fund purpose, philosophy, investment guidelines and, most importantly, fund manager incentives and pay structure?

–How can such investor engagement be consistent with rules against insider trading — and, if investors act collectively (as the Code contemplates), how can legal prohibitions against concerted action be avoided? Is it necessary for the UK Financial Services Authority (FSA) to create a "safe harbor" relating to these disclosure and competition issues?

–What kind of commitments are necessary on the investee company side (perhaps through revisions to the Combined Code) to provide necessary, actionable information to shareholders? And how does institutional investor "oversight" differ from oversight by boards of directors? To what degree will such engagement further divert companies from their central job of high performance with sound risk management and high integrity?

–Can the Stewardship Code be meaningful or effective when many other shareholders are active on the short side or engaged in long-short activity? And how realistic is it to ask hedge funds that choose not to comply with the Code, to explain their business model beyond bromides (as the justification for not wishing to engage with companies)?

–Even for long-term, value-oriented investors, is it possible to avoid "free-rider" issues where a few large institutions engage with companies?

Questions notwithstanding, this UK initiative, with impetus from major UK investor, standard-setting and regulatory entities, bears close scrutiny. It is the most detailed attempt to date to give institutional and regulatory form to the belief that shareholders are part of the solution, not part of the problem, and that they have not just a right, but a duty, to engage with the companies in which they invest.