CFA UK is a member society of

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13th July 2012

CFA UK response to the FRC's Consultation on the revisions to the Stewardship Code

Dear Chris,

The Chartered Financial Analyst Society of the UK (CFA UK) welcomes the opportunity to share its views about the FRC's consultation on changes to the Stewardship Code (Code). CFA UK welcomes any initiative that raises professional standards and market integrity. This response has been prepared by the CFA UK's Professional Standards and Market Practices Committee. CFA UK has not surveyed its members.

The FRC may be aware of CFA UK's views on stewardship which have been set out in its responses to the Kay Review[1]. The FRC may also be aware that the CFA Institute has also published a voluntary code called the "Asset Manager Code of Professional Conduct" (AMC) which may also be relevant to this consultation. The AMC draws on elements in the Code of Ethics and Standards of Professional Conduct that all CFA charterholders and CFA UK members abide by[2] (the Asset Manager Code and the Summary of the Code and Standards are provided for your information).

About CFA UK and CFA Institute

The CFA Society of the UK (CFA UK) serves society's best interests through the provision of education and training, the promotion of high professional and ethical standards and by informing policy-makers and the public about the investment profession.

The society supports the CFA Program® and is the awarding body for the Investment Management Certificate (IMC), the UK's leading entry level qualification for investment professionals.

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[1] CFA UK Response to the Interim Report for the Kay Review May 2012
https://www.cfauk.org/assets/0/Interim_Kay_review_responseSENTdoc.pdf

CFA UK Response to the Initial Kay Review Call for Evidence, December 2011
https://www.cfauk.org/assets/2162/CFA_UK_response_to_the_UK_Equity_Market_Review_SENT.pdf

[2] Asset Manager Code of Professional Conduct, second edition
http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2009.n8.1

Summary of the CFA Institute Code of Ethics and Standards of Professional Conduct
http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2010.n14.1

Founded in 1955, CFA UK represents the interests of approximately 10,000 investment professionals. CFA UK is part of the worldwide network of member societies of CFA Institute and is the largest society outside North America.

CFA Institute is the global association of investment professionals that sets the standard for professional excellence and credentials. The organization is a champion for ethical behaviour in investment markets and a respected source of knowledge in the global financial community. The end goal: to create an environment where investors' interests come first, markets function at their best, and economies grow. CFA Institute has more than 110,000 members in 139 countries and territories, including 100,000 Chartered Financial Analyst® charterholders, and 136 member societies.

The aim of CFA UK's advocacy initiative is to work with policy-makers, regulators and standard-setters to promote fair and efficient-functioning markets, high standards in financial reporting and ethical standards across the investment profession. The society is committed to providing members with information regarding proposed regulatory and accounting standards changes and bases its responses on feedback direct from members or relevant committees

Context

Asset managers and asset owners' investment advisers as regulated entities must abide by the relevant UK regulatory environment. The Code should make sure it complements the regulatory obligations and not overlap with any of these requirements. The FRC is correct that asset managers must adhere to the FSA Handbook and COBS 2.2.3 states -

A firm, other than a venture capital firm, which is managing investments for a professional client that is not a natural person must disclose clearly on its website, or if it does not have a website in another accessible form:

(1) the nature of its commitment to the Financial Reporting Council's Stewardship Code;

or

(2) where it does not commit to the Code, its alternative investment strategy.

This rule is only applicable to managing assets for professional clients and does provide the opportunity for the asset manager to provide an alternative approach with regard to stewardship. In terms of where the primary responsibility of asset managers lie the FSA Handbook is clear; regulated firms should act in the best interests of their clients –

COBS 2.1.1 *A firm must act honestly, fairly and professionally in accordance with the best interests of its client (the client's best interests rule).*

Advisers and asset managers focus on their areas of expertise and this could be strategy driven or asset class driven. Asset owners, especially institutional ones have multi-asset portfolios. Portfolios include a range of asset classes such as fixed income, equity, private equity, property, land and commodities to name but a few. Asset owners will either manage assets in-house of delegate part or all of the constituents of their portfolios. When delegating, asset owners will be keen to allocate capital to asset managers that have a rigorous investment process and an acceptable track record of generating returns. Each asset manager is concerned with generating returns for their respective asset class while asset owners care about the returns generated by their total portfolio not just returns from one asset class.

In our response to the Interim Report for the Kay Review we stated that the asset managers' primary responsibility is to generate returns for the ultimate beneficiary and

this aligns with COBS 2.1.1. This objective can be achieved in a number of ways and attests to the diversity of asset managers that operate in the UK capital markets. By way of example the following list provides an overview of the variety of participants in the UK capital markets –

Investment approaches include, but are not limited to:

- Active, long-only strategies

- Activist – asset managers take large stakes (equity and non-equity) in companies to influence management and strategy.

- Hedge fund strategies e.g long/short, market neutral, merger arbitrage, quantitative funds, algorithmic trading etc.

- Passive strategies e.g funds that track an index like the FTSE All Share or the Markit iBoxx Sterling Liquid Long-Dated Corporate Bond Index; DJ-UBS Commodities Index.

- Arbitrage - seeking to generate returns by exploiting price discrepancies between equity markets and non-equity related instruments.

- Other liability investing opportunities – e.g buying distressed debt and shorting the equity of the same company; buying senior debt and shorting junior debt of the same issuer; investing in the loans of a company.

As can be seen from the above, each type of participant has a different approach. Investors use a variety of strategies so that their investment advisers can construct the appropriate portfolio according to the client's risk appetite, requirements and circumstances.

In relation to public listed companies, liabilities investors can invest in include -

- Equity
- Debt
- Loans

CFA UK takes a different view of equity compared to its treatment in accounting. CFA UK has stated that companies create value when they generate returns that equal or exceed the weighted average cost of capital (which includes the cost of equity). We view all types of capital as corporate liabilities because they are the sources of opportunity cost the company must cover to be economically viable.

Each type of liability or security related to that liability requires its own due diligence process. For example the approach taken to assess the value of a share will be different to the approach taken to assess the risks of a bond issued by the same company. Similarly, investing in the loans made by a company requires a different set of skills and approaches.

CFA UK welcomes the FRC's recognition that asset managers and owners operate in a multi-asset universe. While CFA UK appreciates that engagement is one way to interact with a company it may not be cost effective or appropriate for every asset manager. CFA UK has yet to see robust evidence that demonstrates the value of engagement to investors. However, CFA UK would emphasise that asset managers can "engage" in a variety of ways that is relevant for their investment style/asset class and that this diversity is beneficial to the markets for corporate securities. Exit may be more beneficial

to the asset owner than engagement especially when there is little chance of success as was the case with Kodak.

Asset managers' activities (especially in non-equity asset classes) may influence how companies generate value, although stewardship of corporate assets is not the asset managers' primary objective. Asset managers should also be best placed to make the judgement on the extent to which and how they want to engage with the companies they have invested in. In addition, the FRC should be aware that asset managers do not operate in complete, frictionless markets and so there are barriers to the extent to which they can impose market discipline on companies; otherwise known as Limits to Arbitrage.

Stewardship and the application of the Code

Scope and definition - The Stewardship Code does have regulatory support via COBS 2.2.3 although this is restricted to managing investments for professional clients only. We would hope that the duty of care to clients should be applicable to all client types. As long as investment professionals exercise duty of care and generate returns through legal means with a well defined process; how they generate returns should be for the asset manager to determine and let the asset owner decide how relevant this approach is for their portfolios.

We would also welcome clarification as to which asset classes the Code refers to. At times the Code appears to be referring to equity and non-equity corporate securities (page 4 of the Appendix to the consultation) in other instances it appears that the Code may be only referring to equity securities of publicly listed companies (Principle 3 and 6). In one instance it appears to be looking to apply the Code to all asset classes (page 4); if so, then some of the Principles would need to be amended to reflect the investment characteristics of these asset classes. If the focus is only on securities issued by publicly listed companies than the rest of the Code should align with these types of investments. If the Code is intended to be applicable to a wider set of liabilities of publicly listed companies then the Code needs to have wording that incorporates this diversity.

CFA UK agreed with the Interim Report of the Kay Review that asset managers are the stewards of the funds entrusted to them by investors. That is absolutely correct and all of our members – and candidates in our educational programmes for investment professionals – agree to adhere to a code requiring them to act in their clients' interests at all times. However, the Interim Report goes on to suggest that asset managers 'discharge that function most effectively by acting as stewards of the corporate assets they control by virtue of their management of these funds.' This statement is flawed. Companies generate value while asset managers generate returns, the two do not always have to align.

CFA UK is concerned that the FRC's Stewardship Code may also be taking a too narrow a view of how asset managers should conduct their investment processes by overemphasising engagement. The revised draft of the Code mentions engagement 12 times. Voting is mentioned 19 times and the Code runs the risk of being prescriptive in this sense and at times equity centric.

Comply or Explain

The comply or explain approach is to be supported. This philosophy provides the flexibility to asset managers to demonstrate how they exercise stewardship over client assets in a manner that represents their investment approach and the assets they invest in.

One alternative code that could be used to provide a framework for wider application is the AMC. The FRC would recognise many similarities between its Code and the AMC. Both

have several key features in common, for example the importance of principles. The AMC places more emphasis on client interests and ensuring that asset managers have robust processes in place with regard to their investment approach and maintaining market integrity.

The table below sets out a high level comparison between the Code and the AMC

FRC Stewardship Code	Asset Manager Code
Stewardship activities aim to promote the long-term success of companies so that the ultimate providers of capital also prosper. So as to protect and enhance the value to the ultimate beneficiary, institutional investors should:	The Asset Manager Code of Professional Conduct outlines the ethical and professional responsibilities of firms that manage assets on behalf of clients. This code of conduct is designed to be broadly adopted within the industry as a template and guidepost for investors seeking managers who adhere to sound ethical practice.
1. Publicly disclose their policy on how they will discharge their stewardship responsibilities. 2. Have a robust an effective policy on managing conflicts of interest in relation to stewardship and this policy should be publicly disclosed. 3. Monitor their investee companies. 4. Establish clear guidelines on when and how they will escalate their stewardship activities. as a method of protecting and enhancing shareholder value. 5. Be willing to act collectively with other investors where appropriate. 6. Have a clear policy on voting and disclosure of voting activity. 7. Report periodically on their stewardship and voting activities.	**Responsibilities to their clients.** • Act in a professional and ethical manner at all times. • Act for the benefit of clients. • Act with independence and objectivity. • Act with skill, competence, and diligence. • Communicate with clients in a timely and accurate manner. • Uphold the applicable rules governing capital markets. **Code of Professional Conduct** A. Loyalty to clients B. Investment process and actions C. Trading D. Risk management, compliance, support. E. Performance evaluation F. Disclosures

As can be seen from the above table the FRC Code can be interpreted as being equity centric while the AMC presents a broader approach. Principles 6 and 7 of the Code are related to equity asset managers, there is little in the guidance to indicate how non-equity asset managers should "vote." The AMC takes an approach that is relevant to all types of asset managers and ensuring that they place client interests first, have a robust investment process in place and ensure that they act with integrity. The AMC's view of stewardship is based on client assets; this is shared by the Code although there remains an inference that asset managers should also be stewards of corporate assets. Both the Code and the AMC have some common elements with regard to conflicts management and disclosure and in our view the Code appears to be sub-set of the AMC.

Suggestions to enhance the Stewardship Code

CFA UK welcomes the changes in the Stewardship Code and what these are seeking to achieve in terms of outcomes for the ultimate beneficiary. CFA UK would suggest that the Code could be enhanced in a number of key areas to -

- Asset classes – asset managers could state which assets and markets they operate in. Otherwise if the FRC maintains the proposed wording, with the focus on publicly listed companies, the FRC then should identify which liabilities the Code refers to and amend the Code accordingly.
- Further develop the Principles based foundation of the Code
- Clarify that it can be used as a basis of conduct for all types of asset managers

Asset classes

This section could be completed by asset manager to specify which asset classes and markets they operate in.

Enhancing the Principles based foundation of the Code

The foundation of the Code could start with setting out the responsibilities of asset managers as presented in the AMC. This would be beneficial to clients so that they are clear about the conduct of asset managers. In doing so clients are also aware of the regulatory obligations of their advisers and asset managers.

Responsibilities:

1. Act in a professional and ethical manner at all times.
2. Act for the benefit of clients.
3. Act with independence and objectivity.
4. Act with skill, competence, and diligence.
5. Communicate with clients in a timely and accurate manner.
6. Uphold the applicable rules governing capital markets.

Principles for conduct of asset managers

The next section of the Code could use elements of A, B and F from the AMC and state that this could be used by all asset managers. Sections B and F can be altered by the asset manager so that it is relevant to its investment approach, asset class and the markets it operates in. Parts A, B and F from the AMC are summarized below:

A. Loyalty to Clients

1. Place client interests before their own.
2. Preserve the confidentiality of information communicated by clients within the scope of the Manager–client relationship.
3. Refuse to participate in any business relationship or accept any gift that could reasonably be expected to affect their independence, objectivity, or loyalty to clients.

B. Investment Process and Actions

1. Use reasonable care and prudent judgment when managing client assets.

2. Not engage in practices designed to distort prices or artificially inflate trading volume with the intent to mislead market participants.

3. Deal fairly and objectively with all clients when providing investment information, making investment recommendations, or taking investment action.

4. Have a reasonable and adequate basis for investment decisions.

5. When managing a portfolio or pooled fund according to a specific mandate, strategy, or style:

a. Take only investment actions that are consistent with the stated objectives and constraints of that portfolio or fund.

b. Provide adequate disclosures and information so investors can consider whether any proposed changes in the investment style or strategy meet their investment needs.

6. When managing separate accounts and before providing investment advice or taking investment action on behalf of the client:

a. Evaluate and understand the client's investment objectives, tolerance for risk, time horizon, liquidity needs, financial constraints, any unique circumstances (including tax considerations, legal or regulatory constraints, etc.) and any other relevant information that would affect investment policy.

b. Determine that an investment is suitable to a client's financial situation.

F. Disclosures

1. Communicate with clients on an ongoing and timely basis.

2. Ensure that disclosures are truthful, accurate, complete, and understandable and are presented in a format that communicates the information effectively.

3. Include any material facts when making disclosures or providing information to clients regarding themselves, their personnel, investments, or the investment process.

4. Disclose the following:

a. Conflicts of interests generated by any relationships with brokers or other entities, other client accounts, fee structures, or other matters.

b. Regulatory or disciplinary action taken against the Manager or its personnel related to professional conduct.

c. The investment process, including information regarding lock-up periods, strategies, risk factors, and use of derivatives and leverage.

d. Management fees and other investment costs charged to investors, including what costs are included in the fees and the methodologies for determining fees and costs.

e. The amount of any soft or bundled commissions, the goods and/or services received in return, and how those goods and/or services benefit the client.

f. The performance of clients' investments on a regular and timely basis.

g. Valuation methods used to make investment decisions and value client holdings.

h. Shareholder voting policies.

i. Trade allocation policies.

j. Results of the review or audit of the fund or account.

k. Significant personnel or organizational changes that have occurred at the Manager.

l. Risk management processes.

Other observations about the Code

Voting

CFA UK would agree that voting is important and how this is carried out by the asset manager should be disclosed to the potential investor. It is also essential that how the voting is carried out should be aligned with the asset manager's business model. Some asset managers may possess the resources to devote to voting while others may prefer to outsource. Similarly, other asset managers may prefer a different approach.

The issue of voting is important for equity asset managers although the Code does not provide any principles or guidance about investing in the non-equity securities or loans of a publicly listed company. The contractual parameters of a company's debt and loan covenants differ markedly from the equity capital and will require a different approach that is not possible through the annual general meetings The Code, if it is to be applicable to all asset managers needs to take into account the "voting" dynamics related to all of a company's investable liabilities not just equity. Otherwise the Code should state it is only relevant for equity asset managers. Perhaps Principles 6 and 7 regarding voting could be combined and a new Principle 7 be drafted to address the issue of investments related to corporate bonds or corporate loans.

Stock lending

CFA UK agrees that the stock lending policy should be disclosed to the investor especially how the asset manager manages the risk associated with lending its stock. Some of the larger managers especially those that specialize in passive strategies have set out what their policies are, how the risks are managed and how the benefits from this activity are shared with the ultimate beneficiary.

Here again the Code takes an equity view and needs to expand its line of approach to incorporate how similar lending and borrowing activities take place in relation to non-

equity securities or related instruments like credit default swaps. Non-equity asset managers may also engage in lending and borrowing of bonds and the Code's desire to be principled based should account for this.

Encouraging others to engage collectively

Such activity would have to be undertaken in a way that does not breach the regulations related to concert parties and collusion which would undermine market integrity.

Efficacy of the Stewardship Code

CFA UK has stated in previous responses to the FRC that it is concerned about the efficacy of codes. As we stated in our paper Effective Regulation, one of the key causes of the crisis was ineffective regulation – or rather the lack of effective supervision of existing regulations underpinned by the absence of a credible threat of enforcement. We would ask the FRC to set out how it would respond should it believe its Code was not being adhered to or that the outcomes the Code was supposed to provide are not being realized. Would the FRC make reports to the Financial Conduct Authority? We would also suggest that once the Code beds down the FRC undertake an assessment of how well the Code is achieving its objectives.

Conclusion

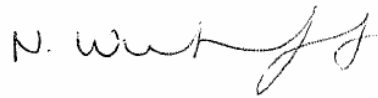
CFA UK welcomes the FRC's ambition in trying to make asset managers more involved in the management of corporate assets and how they should behave in this endeavour. It is commendable that the Code attempts to incorporate the reality that institutional investors hold multi-asset portfolios. However, the Code falls short in key areas and does not fully appreciate the primary responsibility of asset managers, the diversity of approaches by which they generate returns; non-equity asset managers; and their regulatory requirements with respect to their conduct and placing client interests first.

CFA UK appreciates that this latest version of the Code will take some time to bed down, although from our reading of the revised Code, the move from an equity centric Code to a more broadly applicable Code may require further thought in how asset managers investing in other liabilities of a publicly listed companies could abide by this version of the Code. If the focus is only on the liabilities of publicly listed companies then the Code may exclude other asset classes asset owners invest in for example property, commodities and private equity to name but a few. The Code will the apply to a proportion of a client's portfolio not the whole portfolio.

To enhance the areas of the Code, CFA UK suggests that the FRC draw upon elements of the CFA Institute's AMC which should strengthen the Code's principle's based foundation; align with the comply and explain philosophy; be used by all asset managers and contain sections which can be customised to reflect the assets and markets they operate in. In doing so, the Code becomes a stronger more coherent initiative that is relevant to asset managers and provides the end beneficiary clarity about the manager's responsibilities and conduct in generating returns for their portfolios.

We hope our response is helpful and we would be open to discuss it further with you.

Yours,



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