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27 March 2019
Via email to cp19-07@fca.org.uk

David Stubbs
Primary Markets Policy
Financial Conduct Authority
12 Endeavour Square
London
E20 1JN

Re: CP19/7 Financial Conduct Authority Consultation on proposals to improve shareholder engagement

This is a joint response from UKSA and ShareSoc on behalf of individual investors.

UKSA and ShareSoc represent the interests of private shareholders. In addition to our own members, there are 5 million people who own shares and have investment accounts with platforms in the UK. The Office for National Statistics estimates that individual investors own 12% of the UK stock market by value. In addition to this there are many more who have money invested in shares via funds, pensions and savings products such as employee share ownership schemes.

Below we make a number of points, with further background in the Appendix. We think this is important context to our response to your consultation as there are broad issues that impact on the implementation of the EU Shareholder Rights Directive II, the Stewardship Code review and the joint FCA/FRC Discussion Paper-Building a regulatory framework for effective stewardship and to only respond in a narrow way to your specific questions might mean you missed the bigger picture.

1. The title of this consultation is confusing and misleading, ie "Consultation on proposals to improve shareholder engagement". This consultation only relates to the implementation of those parts of the EU Shareholder Rights Directive II that relate to stewardship, which have to be harmonised into UK Law.
2. We note para 1.9: *The implementation of SRD II through the FCA proposed new rules for asset owners and asset managers sets an important baseline in a continuum of measures to drive effective stewardship.* The revised Stewardship Code aims to encourage higher standards beyond this baseline. Many of the 28 EU states are considerably less advanced than the UK. The UK operates to much higher standards and in so doing has a competitive advantage. FCA proposed new rules may recognise this. Therefore, the FCA can and should consider the role of individual investors in engagement and stewardship.
3. The role of individual investors in engaging with companies and stewardship should be given more weight in the FCA considerations.
4. We very much welcome the reference to The Law Commission Review of Intermediated Securities, in para 4.13 on page 17 of DP19/1. This Law Commission Review must be given a much higher priority if retail investors are to exercise their role as stewards of the companies in which they invest. Retail investors own, on average, 29% of AIM companies and 12% of main market companies. They are a non-trivial constituent to the engagement and stewardship issue.
5. Investor Engagement and Stewardship should not be looked at in isolation from fund performance and fund fees. The proposed requirements for fund managers to report annually to

asset owners should be enhanced by performance data and tracking error statistics. It is important that these high-level reports contain information that will highlight closet indexing. (see answer to question 3).

6. Asset owners should have to report to beneficial owners on their stewardship principles and how they have operated these principles in practice in the past year. (see answer to question 5).

Our specific answers to your questions are as follows

Q1: Do you agree that the territorial scope of the rules framework should extend beyond that envisaged by the Directive?

Yes

Q2: Do you agree with our proposed amendments to the Handbook to implement the Directive requirements around engagement policies? If not, please explain what alternative approach you would like us to take.

Yes, except that you should add to 3.4.7 R(1) the words "in a user-friendly format such as Excel".

We have evidence of companies and fund managers providing information in extremely unhelpful pdf formats and in so doing failing to follow the spirit of laws, regulations and best practice guidelines. Our experience suggests that this slight change to the regulation is necessary, because of the failing cultures of many financial services firms. We can provide you with examples if you wish.

Q3: Do you agree with our proposed approach to implementing article 3h of the Directive? If not, please explain what alternative approach you would like us to take?

Fund managers should be required to report back to asset owners on their performance stewardship and engagement. This should cover the following information:

– the key material medium to long-term risks associated with the investments – portfolio composition
– turnover
– turnover costs

- Performance in absolute terms and versus benchmark(s)
- Tracking error
- Significant buys and sells of shares in the period under review (e.g. top 5 of each) and performance (absolute and relative to benchmark(s)) of
  - Newly bought shares
  - Sold shares
  - Rest of the portfolio
- The major engagements (e.g. top 5) in the period and the outcomes achieved and any other major activities, e.g. a letter sent to all investee companies.
- Summary of votes in the period (number of votes, number for, against, abstain, withheld), plus trend data to compare with historic practice and explanatory commentary.
- Fees charged in the period, split between management and performance fees if performance fees are charged.

– whether and if so, how the asset manager uses proxy advisors for the purpose of their engagement activities

– their policy on securities lending and how it is applied to fulfil engagement activities, if applicable, particularly at the time of general meetings of companies they invest in

• whether, and if so, how they make investment decisions based on an evaluation of medium to long-term performance, including the non-financial performance, of the companies they invest in

• whether any conflicts of interest have arisen in their engagement activities, and, if so, what they are and how the asset manager has dealt with them

The points highlighted in yellow in red font are additional to those on page 17 para 3.35 and Annex C (COBS) of CP19/7. Similar changes would be need to the drafting in Annex B of CP 19/7.

We also note the difference between asset allocation and stock selection and the need to report on both of these aspects of stewardship.

Q4: Do you agree with our proposed amendments to implement the Directive requirements on asset managers reporting to asset owners? If not, please explain what alternative approach you would like us to take.

Please see answer to Question 3.

With reference to para 3.39, fund managers will be reporting back to their clients on a regular basis not only as part of their agreed service levels but also to retain the business when it comes up for renewal with the hope of winning additional mandates.

If the fund manager makes information available publicly the fund manager should still have to provide it to their client. This ensures clients get the basic information in front of them in a consistent manner.

Q5: Are there any other points we should address in the Handbook in relation to the SRDII, for example by adding clarificatory rules or providing further guidance?

In para 3.41 you say "We do not propose to set out a standard way in which firms must disclose the information, and will not require it to be provided in a single report. We believe this approach will provide flexibility."

We do not agree with your conclusion. We think it will add complexity and create confusion and a lack of transparency.

We think you should define these terms and ask firms to report information in a consistent standard format, using agreed definitions.

In addition, asset owners should have to report to beneficial owners on their stewardship principles and how they have operated these principles in practice in the past year.

Q6: Do you agree with how we are proposing to implement SRD II requirements on related party transactions in the DTRs (including our proposal to replicate existing LR provisions so far as possible and choosing a threshold of 25%)? If not, please explain what alternative approach you would like us to take.

We have no comment to make in relation to this question.

Q7: Do you agree with our proposed amendment to the LRs – in particular that we should extend our rules for related party transactions to all issuers with a premium listing (except those subject to LR 16) or with a standard listing of shares that have their registered office outside of the UK or other EU Member State? Further, do you agree that we should give recognition to compliance with equivalent standards in non-EU jurisdictions and, if so, what are your views on how this could best be achieved?

We have no comment to make in relation to this question.

Q8: Are there any other points we should address in our rules for related party transactions in relation to SRD II?

We have no comment to make in relation to this question.

Q9: Do you agree with the conclusion and analysis set out in our cost benefit analysis?

We have no comment to make in relation to this question.

To ensure that our response is read with a view of the bigger picture, we have included further context in the Appendix to this letter.

We would of course be happy to meet with you and explain our views in more detail.

Yours faithfully,

Cliff Weight, Director, ShareSoc

Peter Parry, Policy Director, UKSA

Appendix. Further Context

Below we make a number of points. We think this is important context to our response to your consultation as there are broad issues that impact on the implementation of The EU Shareholder Rights Directive II, the Stewardship Code review and the joint FCA/FRC Discussion Paper-Building a regulatory framework for effective stewardship and to only respond in a narrow way to your specific questions might mean you missed the bigger picture.

What do we mean by Stewardship?

The dictionary (Merriam Webster) defines stewardship as:

> 1**:** the office, duties, and obligations of a steward
>
> 2**:** the conducting, supervising, or managing of something, especially**:** the careful and responsible management of something entrusted to one's care

It adds:

> *When stewardship first appeared in English during the Middle Ages, it functioned as a job description, denoting the office of a steward, or manager of a large household. Over the centuries, its range of reference spread to the oversight of law courts, employee unions, college dining halls, Masonic lodges, and many other organizations. In recent years, the long-established "management" sense of stewardship has evolved a positive meaning, "careful and responsible management."*

In a company, most of the stewardship is undertaken by the executive management. However, the NEDs have a very important role in stewardship, in monitoring performance and ensuring capital is allocated wisely. Capital is provided to companies by investors, including asset owners and asset managers are an important cog in this wheel. We must not forget that most of stewardship is done within the company and when companies fail it is the most usually the responsibility of the management. The primacy of the responsibility of NEDs and management for stewardship must not be overlooked.

DP19/1 defines stewardship somewhat differently and more accurately should be described as investor stewardship:

> *"We define stewardship as the responsible allocation and management of capital across the institutional investment community, to create sustainable value for beneficiaries, the economy and society. Stewardship activities include monitoring assets and service providers, engaging issuers and holding them to account on material issues, and publicly reporting on the outcomes of these activities."*

This definition looks incompatible with what several leading fund managers told us (in meetings in 2018) that they see as the **fiduciary duty** of fund managers to their clients. We were told that fund managers would see their primary (and possibly their only) duty to be to their clients, an example may clarify: when evaluating a decision on selling GKN shares to Melrose, the fund manager considers only the financial consequences and not the impact on employee, communities, the economy and society.

The 2012 Stewardship Code identified the aim of investor stewardship as delivering long-term value for beneficiaries while recognising that this also benefited the economy as a whole. We are concerned that the proposed new definition of Stewardship loses this important distinction in the motivations of institutional investors. This might be addressed by, for example, including "and hence" between "beneficiaries" and "the economy and society".

The long-term health of economies is likely to lead to increases in sustainable value for investors; this should be a guiding principle for asset managers and asset owners; it prompts the view that they should be seeking to engage with and influence governments and policy-makers as well as influencing directors in investee companies and the issuers of other securities.

The approach to stewardship will vary for different asset classes; the concept of stewardship, however, is relevant to all asset classes. It is perhaps particularly important that it is recognised as of value for debt instruments as well as equities and for asset allocation.

The definition helpfully encompasses both the long-term financial value sought by beneficiaries and the additional benefits to them of a healthy economy, society and environment and the ability to invest, when they wish, in line with their ESG preferences

However, the definition is too narrow as it excludes **individual investors**. Individual investors own 29% of AIM and 12% of the main market by value. They have an important role in stewardship and to ignore them is wrong.

A problem with the definition proposed by the FCA/FRC is that it focusses on processes rather than a **balance of outcomes and processes**. Sir John Kingman has highlighted his concerns in this regard, and we agree with him in this respect.

A useful parallel is with the annual report and accounts. The financial accounts themselves are backward looking, a statement of the balance sheet at the end of the year and an estimate of trading performance in the year. It is a little like driving a car by looking only in the rear-view mirror. The financial accounts tell us about lagging indicators of company performance. This is important but it is only for part of the story.

The KPIs and the narrative reporting give an indication of future performance and some of the KPIs are leading indicators of future performance (customer satisfaction ratings give an insight of future sales: employee satisfaction surveys and staff turnover an insight into employee motivation, incentivisation and future performance and costs; etc).

We approve of the emphasis on "responsible" asset allocation and "sustainable value". In 2000, too much capital was allocated to the dot.com boom/bubble and huge amounts were lost. In the run up to 2008/9 Financial Crisis, too much capital was allocated to banks and huge amounts were lost. At various times, too much capital has been allocated to mining with the result of overcapacity and slumps in commodity prices. Builders have a history of over-expansion, and it was notable that following 2009 a number of new incentive schemes were implemented to incent executives to pass back excess capital to shareholders: these were successful in better asset allocation and produced significant returns for shareholders (and various scandals over excessive pay, e.g. Persimmon, Berkeley Homes). The emphasis on momentum as an investment style has had a history of producing good short-term results (and has been incentivised by remuneration packages – Kay noted this) and has enabled asset managers to win new business.

We note in our response the difference between asset allocation and stock selection and the need to report on both of these aspects of stewardship. The Stewardship Code is not sufficiently specific in this respect.

Code Name

We think calling the Code the Stewardship Code is misleading. **Investor Stewardship Code** would be better and be closer to what the Code tries to do.

Ideally the Investor Stewardship Code should include reference to individual investors and their role. If it does not, then the Code ought to be called the Institutional Investor Stewardship Code.

The current regulatory framework

Companies under the Listing Rules have to explain how they have complied with the provisions of UK Corporate Governance Code, which is itself a comply or explain Code.

A similar rule in respect of the [Investor] Stewardship Code would be sensible.

Companies now have to explain how they have operated in respect of their S172 requirements. Some clarity about the fiduciary requirements of the fund managers and asset owners would be welcome. The proposed [Investor] Stewardship Code seems to suggest some responsibilities beyond the current fiduciary duties. It would be helpful for there to be clarity on the regulatory role and that element that may or may not be viewed as a market competitive strategy.

Background re high fees and poor performance of asset managers

We note that the 2016 FCA Asset Management Market Study Interim Report MS15/2.2, noted inter alia:

- *The annual average disclosed fee for actively managed equity funds available to UK investors is 0.90% of the assets under management (AUM) and the average passive fee is 0.15%. Furthermore, transaction costs (charged when asset managers trade on investors' behalf) are normally higher for active funds (as illustrated in Figure 1.2). (p10 para 1.3)*
- *Asset management firms have consistently earned substantial profits across our six-year sample, with an average profit margin of 36%. These margins are even higher if the profit-sharing element of staff remuneration is included. (page 14, para 1.21)*

These were damning criticisms of the industry. There are very relevant to this discussion paper as stewardship requires resources and, we argue, excessive profiteering is one of the reasons that asset managers and asset owners under resource stewardship activities and provide a high cost, poor service as a result.

The criticisms are also relevant to this consultation paper as unnecessarily high fund manager fees are extremely concerning to asset owners and to the ultimate beneficial owners. Costs and performance can be of far more significance than how the fund manager addresses stewardship. We think these issues need to be addressed at the same time. We worry that an over focus on stewardship may be a diversion from the more major problem of fees and performance.

Voting of shares held by Retail Investors

The ability of beneficial shareholders who hold their shares in nominee accounts being able to vote their shares easily and at no additional cost is a critical aspect of shareholder rights and shareholder democracy. **Any regulatory proposals that fail to address this point can only be a partial solution.** The Law Commission Review of Intermediated Securities (see para 4.13 of the DP) must be given a much higher priority.

Currently only 6% of retail shareholder vote at AGMs. This is because of the difficulties, for those holding shares via nominees, that platforms have created. The platforms are not facilitating shareholders exercising their voting and other rights.

In addition, the shareholder register does not require the name on register of the beneficial owner of shares held via nominees. Currently, HM Government has no plans to change this, despite it being a clear objective of the EU Shareholder Rights Directive. The Law Commission review of Intermediated Securities must (as noted above) be given a much higher priority. The FCA/FRC support in this issue would be most welcome. Being able to communicate with shareholders would allow the registrars to offer an alternative service to platforms.

In our response to the Platforms Consultation, UKSA-ShareSoc called upon the FCA also to examine these issues:

1. **A new "name on register" electronic system** needs to be provided if "dematerialisation" is to fully happen so that investors can buy and sell shares through any broker and not be locked into one broker as happens at present.
2. The protection of holdings in nominee accounts by alleged "ring-fencing" of client holding and cash which is totally undermined by the rules in the Special Administration Regime (e.g. the case of Beaufort).
3. The relatively low protection provided by the Financial Services Compensation Scheme in relation to the amounts likely to be invested in platforms, e.g. in pension SIPPs and ISAs.
4. The basic poor legal protection offered by nominee accounts and the failure of almost all stockbrokers to offer personal crest accounts (i.e. where your name is on the share register of the company and your holdings therefore clearly legally your own and not the platform operators).
5. Similarly, the requirement to use nominee accounts for ISAs and SIPPs is deeply uncompetitive because it locks clients into one platform from which they have difficulty withdrawing.

The above issues do not seem to be covered by this consultation paper nor the other discussion paper but are major contributors to the current uncompetitive environment for retail investors in respect of platform operators and hence for retail investors to vote their shares and engage pro-rata to the amount of their investments in companies (on average 29% of AIM companies and 12% of main market companies).

Hence, we call upon the FCA to begin a CMA review of the conduct of platforms and custodian banks, the primary operators of nominee services. The shareholder voting plumbing is broken and there are many vested interests who are interested in tinkering at the edges than ensuring that the law works as it was intended. This review will review how retail shareholders rights can be restored. In doing so, companies will be able to develop productive relationships with their providers of capital.

Closet Trackers

Another area of concern for us is closet trackers, where funds charge exorbitant fees for a service which is closer to a tracker fund. We note however the recent FT report on the 5 Feb 2019 FCA publication https://www.fca.org.uk/publication/policy/ps19-04.pdf by Owen Walker, Asset Management Correspondent FEBRUARY 4, 2019: FCA orders more fund disclosure from asset managers Watchdog targets 'closet trackers' charging high fees for active management.
https://www.ft.com/content/693fd46c-2867-11e9-a5ab-ff8ef2b976c7

Nevertheless, we think these closet tracker issues need to be captured by regulatory rules and/or the Stewardship Code. Our response to Question 10 refers to this point with specific recommendations.

The current engagement processes

Our analysis of the main problems in the current engagement process is as follows:

- The informal nature of most current shareholder engagement (cosy chats with selected shareholders behind closed doors) does not work well for the broad shareholder base. It is not clear whether investors are each being told the same story, how information is being spun, or whether complete or only partial information is being given out. Investors will ask different questions during engagement meetings and so may develop different interpretations of what the company is trying to achieve. Ad hoc engagements tend to only occur when a problem arises.
- Currently, when a large number of investors are "consulted", it is difficult to have the same conversation with each investor and the proposal often changes over the process of engagement. Currently, the different views of different investors create a very "messy" backcloth in which to engage. For example, in relation to remuneration proposals, there is often no clear trail from the initial proposal though to the final version voted on by shareholders.
- Voting happens too late in the process. Proxy votes are lodged before the AGM without the benefit of hearing the AGM discussion. Discussion and voting at the AGM is ineffective, as

institutions do not like to vote against the directors' recommendations. A more professional and systematic process is required.

There is clear evidence of engagement not working, i.e. surprises, adverse voting results and numerous bad cases of corporate governance. The 20% Naughty register https://www.theinvestmentassociation.org/publicregister.html has many more cases than expected. 152 companies in the FTSE All Share Index were "naughty". The BEIS Committee report on executive pay highlighted the problems. It named and shamed serious offenders, and criticised the investors and remuneration committees for failing to address the problems.

Fund Managers, the Investment Association, the Investor Forum and companies keep repeating the mantra that engagement is getting better. It may be, but it is nowhere near good enough. The arguments they put forward are specious and self-serving.

We are arguing that individual investors have good points to make and need a voice in company-investor engagement. Our arguments/rationale/logic have been fiercely resisted by the fund management industry.

There are reasons why **fund managers can be particularly bad stewards** – i.e. quite the wrong people to be voting shareholders. Reasons include Index-following, short-termism, free-riding, need not to upset. There is more evidence in UKSA's Responsible Investing booklet from 2010. http://www.uksa.org.uk/sites/default/files/responsible_investing_2010_members.pdf . It also contains some information on why individuals can be particularly good stewards (they have a long-term focus, their own money is at risk, among other things).

Persimmon is the latest UK governance disaster. Others in 2018/19 include Carillion, Conviviality and Patisserie Valerie who all had accounting issues and Aviva and Unilever with awful corporate governance where directors failed to listen to, or understand, what shareholders/investors/ fund managers were saying.

Nevertheless, ShareSoc and UKSA are currently losing this argument about engagement, which proves that even if your arguments have intellectual rigour, you do not always win the argument - in the short term. We will win this argument only if retail shareholders can be heard. Alas, the big City beasts freeze us out. This is probably a breach of several regulations about orderly markets, all shareholders having the same information etc, etc. Part of the reason why we run the RBS Shareholder Committee Campaign is to highlight the very limited information that is shared with individual investors.

AGMs should be the basis of successful engagement, prefaced by analyst type meetings, shareholder meetings and structured discussions on corporate governance issues of concern.

A lot more work needs to be done to make AGMs more effective. Our members attend many AGMs and, in many cases, write excellent writeups which are put on our website for other members to read. This is viewed by our members as a useful service.

How to involve Individual Investors in shareholder engagement

As well as the AGM, we suggest regular meetings between companies and groups of individual investors. Such meetings with companies and UKSA/ShareSoc have been held for over 10 years.

Three examples of good practice are HSBC, BHP Billiton and Marks and Spencer.

BHP Billiton

We (UKSA AND ShareSoc) organise a series of events for individual investors to meet the companies they invest in. Probably the best model for this is BHP Billiton who (in conjunction with

UKSA+ShareSoc) have **very successfully** run such investor events for over 10 years. Here is a link to the recent event. https://www.sharesoc.org/news/bhp-billiton-retail-shareholder-event-18-sept-2018/

The BHP example is particularly relevant, as BHP suffered very well planned, coordinated actions by various action groups at its AGM which somewhat highjacked it from what many would view as the main purpose of the AGM, to interact with its shareholders and to vote on important resolutions. Cliff Weight was one of those real shareholders at the BHP AGM and found enlightening the degree of concern and the range of issues that were covered. The fact that meetings outside of the AGM had not been able to satisfy employees, labour unions, conservation groups, environmentalists, local communities, etc raised concerns for shareholders about how well the BHP Billiton Board were listening. It was difficult as an observer in what was a highly emotional atmosphere to evaluate the issues. However, having been present at the previous shareholder event (2 months previously) where many of the same the issues had also been raised and discussed he felt that the BHP management are doing a pretty good job in very difficult circumstances. One factor that swayed his view was the time that BHP had dedicated to talking to its retail shareholders in Australia and the UK and also the BHP commitment which was reflected in the length of time they had been engaging in this way.

HSBC

HBSC are another role model and they tend to schedule their event about a month before their AGM which gives the Chairman a chance to rehearse some of the likely AGM questions. These meetings with UKSA/ShareSoc have been held for over ten overs.

Meeting agenda and how it is run

The presentation is usually similar (or the same) as that given to institutional investors/fund manager/analyst events. We don't wish to demean issues like branch closures, customer complaints, etc, but investors in shares want to know about and focus the event on factors that are crucial to the share price now and in the future.

M&S Shareholder Panel

M&S ask for volunteers each year to join a panel of shareholders. About 6 meetings are held each year including a Christmas lunch event. These meetings provide an opportunity for M&S directors and senior executives to discuss issues of concern and for shareholders to raise questions and issues that they believe are important. M&S have done this since 2016.

More information is at https://corporate.marksandspencer.com/investors/shareholder-information/faq/shareholder-panel which explains:

> Why is M&S doing this now?
>
> In 2016 we invited a number of shareholders to M&S's Head Office for our very first Shareholder Panel, providing a platform for them to offer their views on the issues that are of most concern to them as investors, and to hear about how the Company is addressing these directly from members of the senior management team. This was hugely successful, and very well received by those who attended, and it was therefore decided to introduce a regular event and for which all registered shareholders can apply to attend.

Shareholder Panels and Shareholder Committees

We see a role for meetings between companies and representatives of shareholders on a more formal and structured basis as part of a successful engagement policy with shareholders. The current ad hoc approach fails to build trust.

We have submitted a shareholder resolution to RBS to include a resolution at the AGM to implement a shareholder committee, for the 2017, 2018 and 2019 AGMs. At the 2018 AGM 5.5% of votes were in favour of the shareholder committee (the 5.5% figure excludes majority shareholder UKGI who voted against our proposal).

Making stewardship possible

Consider a fund manager with 4,000 shares. Reading each annual report in detail is not possible. It is also not sensible for 200 fund managers to each read every single one of the 4,000 annual reports (in the case of Blackrock and Vanguard they have 40,000 companies to read).

The obvious and best solution is to outsource this and get the outsourcer to highlight those companies that may be of concern to the fund manager.

This requires a screen (some might call this a template) whereby an algorithm can come up with a score to highlight companies of concern. ISS, Glass Lewis, Minerva, PIRC and IVIS provide this service to fund managers and asset owners.