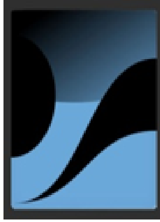

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25th March 2019

Via email to stewardshipcode@frc.org.uk

Corporate Governance and Stewardship Financial Reporting Council
8th Floor
125 London Wall
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Re: Proposed Revision to the UK Stewardship Code 2019

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.

We believe that the proposed revisions to the Stewardship Code are a sound attempt to make the Code more meaningful and to give it teeth. However, we have concerns that in some areas the Code is seeking to set expectations on which it will be very difficult to deliver and which could ultimately result in the Code becoming discredited. **In particular, we are concerned that there is almost no guidance on how information which demonstrates excellent stewardship can be effectively communicated to those who have most need of the information, namely the end-investors**. Key observations are:

1. The 2012 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".

2. 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.

3. 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.

4. 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.

5. The Stewardship Code should be renamed the **Investor Stewardship Code** to better reflect what investors do and to better acknowledge the role of management and Boards in the stewardship of their shareholders' capital.

6. While the Code recognises that not all investors practice Stewardship, it could make it clearer that practices such as short selling may have objectives centred on corporate failure and hence value destruction in ways that may impact other holdings of their own beneficiaries and undermine good stewardship by others. The Code could usefully require signatories to explain whether or not they undertake such practices and, if so, how they justify them and, if not, how they seek to minimise their impact on sustainable value creation. Furthermore, funds that 'lend out' stock which may be used for short-selling by others should give details of stock that they have lent out (regardless of the use that the counterparty intends to make of the stock).

7. There is plenty of scope to encourage collaborative action by asset managers and asset owners– particularly across geographical borders and when dealing with governments and other key influencers of economic policy.

8. We agree that the use of the Code should remain voluntary.

9. The introduction of Activities and Outcomes (A&O) reporting is an important innovation which has the scope to ensure that subscription to the Code is meaningful. A&O reporting should be closely monitored following introduction and asset managers should be given whatever help they need to ensure that their A&O reporting meets expectations.

10. The Guidance should include examples of what 'best practice' in stewardship reporting looks like; for the avoidance of doubt, examples of poor practice should also be given.

Issues such as asset allocation and the choice of companies within each component of allocation are essentially operational matters. However, good stewards should report on these issues and the contribution that each makes to fund performance to the beneficiaries on an annual basis. This should be an explicit requirement under Provision 15 of the Code.

Our responses to your specific questions are shown below.

Consultation questions

Q1. Do the proposed Sections cover the core areas of stewardship responsibility? Please indicate what, if any, core stewardship responsibilities should be added or strengthened in the proposed Principles and Provisions.

They probably do. The key question is how well this system of classification for 'core areas' works in practice. There needs to be a post-implementation review in about two years time, similar to the review that the FRC has carried out recently for Ethical and Auditing Standards. The Outcomes and

Activities reports are also likely to show very quickly how well the proposed sections work in practice.

It is appropriate to suggest that the primary purpose of stewardship is one of looking after the assets of beneficiaries that have been entrusted to the care of others. It is also appropriate in our view to claim that this also broadens the scope of the Code to be applicable beyond UK listed equity assets.

However, we have concerns about the definition of stewardship in the Code. Section 1 of the Code, 'Defining Stewardship,' states that:

> 'Stewardship is the responsible allocation and management of capital across the institutional investment community to create sustainable value for beneficiaries, the economy and society'.

We accept that what is good for the economy is likely to be good for investors and that these two aspects of stewardship ought logically to be aligned. Similarly, it has long been recognised that companies need to achieve and maintain societal consent to operate effectively over the long-term.

However, as described above, we are concerned that the definition does not recognise more clearly the primary motivation of institutional investors of creating value for beneficiaries.

The definition does helpfully encompass 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.

Section 4 of the Guidance should be strengthened to give a clearer commentary on how asset managers should communicate with their investors – particularly their retail investors. Some, asset managers such as Fundsmith, hold an annual meeting which investors can attend and at which the management gives a review of their activities and the outcomes. Investors have a chance to ask questions and meet management. This approach is to be applauded. Too many are content to provide information which is incomplete, superficial, difficult to understand, difficult to access difficult for investors to find their way around and difficult to analyse. The Code requires asset managers and owners to provide significant amounts of information on their activities in order to demonstrate their commitment to stewardship. This information is only of any benefit if it can be easily accessed and understood by most investors. Many may not be particularly sophisticated and may not have the time or resources to plough through pages of jargon and incoherent data.

Q2. Do the Principles set sufficiently high expectations of effective stewardship for all signatories to the Code?

Probably not; we have summarised a number of issues for consideration below. The best solution might be to issue the revised Code and in the light of the A and O reports being submitted consider what changes might be required to the Principles.

2.1 The broad view: Keith Skeoch, CEO of Standard Life Aberdeen writing in the Financial Times[1], notes that corporate failures such as Carillion, Lehman Brothers and Enron caused pension funds and

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[1] Financial Times; FM supplement, Monday, 25th February – 'Business has to regain trust. Stewardship is the way to do it'.

other investors to suffer heavy losses. He goes on to say that, arguably, the effects on workers who lose their jobs and suppliers whose contracts are terminated are even greater. The damage done to communities can last years.

Despite this, much of the asset management industry operates on the basis that its interests are best served by ensuring that its own profits are maximised. The industry needs to adopt a more thoughtful approach to creating sustainable value.

The FT article identifies three key steps required to improve stewardship:

- The legitimacy of asset managers hinges on what they deliver for savers. Savers often have wider interests than (short term) financial return. This has to be at the centre of the way in which fund managers approach stewardship;
- ESG issues **that matter to savers** are an essential component of the process that delivers financial return;
- Asset managers need to recognise that what is good for equity shareholders is not always in the interests of everyone.

It might reasonably have added that what is in the interests of asset managers is not necessarily in the interests of savers or anyone else – for example, excessive focus on short term returns. This fact notwithstanding, the three key steps are a good place to start in deciding whether the Principles set sufficiently high expectations of effective stewardship for signatories to the Code.

2.2 Asset Owners: We should separate the stewardship responsibilities of asset owners, asset managers and companies.

Asset Owners have 3 stewardship roles:

1. Asset Allocation -e.g.
    - which classes? e.g. cash, gilts, bonds, equities, infrastructure, PE, hedge funds;
    - which geographies? e.g. UK, US, Europe, Japan, emerging;
    - within equities, which sectors?

    This is arguably an operational role rather than a stewardship role - although it clearly impacts heavily on the returns they achieve for their investors and perhaps the sustainability of those returns.

2. Monitoring of investments in companies, engaging when necessary, voting at GMs and when necessary selling shares (or buying more if the governance is good?).

3. Instructing their asset managers on the asset owners' stewardship policy and monitoring of asset managers activities with regard to stewardship.

Much of the debate about stewardship is about item 2 on the above list. However, item 1 is arguably the most important.

Asset allocation can often involve be a very long-term commitment decisions. Hence measuring performance over the short term can be misleading. For example, if you are concerned about climate change and the need for action, this will influence if and how you would invest in each of coal, oil, nuclear, solar and wind.

Asset managers manage assets on behalf of asset owners and, in the case of retail funds, on behalf of the beneficial owners.

Within the investee companies, the NEDs perform a valuable role of monitoring how executive management allocate capital and run the business. Boards (the majority of who are NEDs) will seek to preserve capital, to manage risk as well as to make entrepreneurial investments.

2.3 Overseas investors: We also have concerns over the extent to which the Code may or may not apply to asset managers outside the UK. The Office for National Statistics (ONS) estimates that in 2016 some 54% by value of shares in UK listed companies was owned by investors outside the UK. This compares with 30.7% in 1998. The concern is particularly acute when it comes to issues such voting on directors pay. According to the Financial Times[2], big US asset managers stand accused of rubber-stamping exorbitant executive pay deals in the US, as the income gap between bosses and staff grows even wider.

Fund groups, including Fidelity Investments, BlackRock and Axa Investment Managers, opposed just a handful of the 100 biggest pay deals last year, according to As You Sow, the California non-profit group. Northern Trust, the $1.1tn manager that mainly serves pension funds, did not vote against any pay deals. At the other end of the scale, European asset managers appear to have acted much more responsibly. Royal London Asset Management voted against 89% of pay awards, Allianz Global Investors against 78%, BNP Paribas against 69% and Schroders against 63%.

Q3. Do you support 'apply and explain' for the Principles and 'comply or explain' for the Provisions?

Basically, yes.

Those parts of the EU Shareholder Rights Directive II related to Engagement are being translated into UK law (See FCA consultation CP19/7) and form a legal framework of what must be done. The Stewardship Code needs to make reference to the legal framework.

Q4. How could the Guidance best support the Principles and Provisions? What else should be included?

It might be better if the guidance were to become a separate document. It should be expanded to give examples of what 'good' and 'inadequate' look like – or, at the very least, what best practice looks like. At present the guidance is long on suggesting how procedural and quasi-regulatory requirements can be met. It is short on practical examples of what signatories might be expected to say, in terms of **evidence** presented, to achieve a good rating. Evidence should be output focussed whenever possible.

The FRC must avoid a situation in which asset owners and fund managers produce reports that obfuscate and/ or consist largely of plausible boilerplate. One of the assessment criteria for the A & O reports should be the effective use of plain English.

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[2] Financial Times 21.2.19 – Fund groups nod through huge CEO pay deals says non-profit group. Fidelity, BlackRock, Axa IM and Northern Trust opposed handful of 100 top packages.

The financial services industry in general has an impressive record saying fine words about engagement and stewardship, but failing to translate the words into action. Actions speak louder than words. Actions are also a better indication of the underlying culture of the organisation.

Q5. Do you support the proposed approach to introduce an annual Activities and Outcomes Report? If so, what should signatories be expected to include in the report to enable the FRC to identify stewardship effectiveness?

Yes, this is a critical requirement. Two key reasons why the Code has been largely ineffective in the past have been:

i. signatories have had only to write a one-off submission which sounded plausible and which they could then file and ignore.
ii. Their reports on voting have been in pdf format which have been very hard for external interested parties and the press to analyse; and consequently, little analysis has been done apart from the fine work by ShareAction which has been very labour intensive. Reports needs to be in a format prescribed by the FRC, the format should be consistent. The use of XMDR or something similar to EDGAR in the US should be considered.

As indicated in the response to Q1 above, the content of the A & O Reports will vary depending on the nature of the fund (UK equities, UK Corporate bonds, Private equity, emerging markets etc) and whether funds have an ethical or environment or similar objective.

Some thought needs to be given to the limitations of individual A & O reports. Thought should be given to the possibility of amalgamating certain information in a single database. This would be valuable for things like voting on director reappointment and directors' pay. It would provide an immediate and very visible overview of voting patterns and who was taking their voting responsibilities seriously. However, when a fund has adopted a particular governance stance, then it will be important to report on when it has voted/engaged differently to the firm's "normal" governance approach. A green fund might be an example of this.

When fund managers report on initiatives they have taken during the year they should adopt a reporting framework in which they state the number of initiatives that have taken in the year and for each initiative:

- The nature of the initiative taken and its objective;
- What they did
- The outcome and what further follow-up is planned.

If there have been a large number of initiatives it may be appropriate to only report on the most important initiatives in detail, with a summary of the others.

The detail of what should be included in the A & O report is difficult to specify with no prior experience of this approach. Arriving at the right type, quantity and depth of content is likely to be a matter of trial and error. The FRC should review the content of the first year's A& O reports. It might also be appropriate to make this the subject of a Reporting Lab project.

Q6. Do you agree with the proposed schedule for implementation of the 2019 Code and requirements to provide a Policy and Practice Statement, and an annual Activities and Outcomes Report?

Yes.

Q7. Do the proposed revisions to the Code and reporting requirements address the Kingman Review recommendations? Does the FRC require further powers to make the Code effective and, if so, what should those be?

We believe that the proposed revisions are a serious attempt to address the recommendations of the Kingman Review. The annual Activities and Outcomes Reports should play a key role in meeting Sir John's recommendations. It will be important to react to whatever emerges from the implementation of the Code and to amend it as necessary. It would be appropriate (as indicated above) for the FRC to give clearer guidance about what it expects to see in the A & O reports based on experience gained in the early years of reviewing these reports. The FRC may need further powers to make the Code effective. It is not clear at present what these might be.

In short, the implementation and management of the revised Code has to be an ongoing responsibility for the FRC or, following the proposals from Sir John Kingman, its successor. Care should be taken not to fall into the trap of applying more regulation to try and improve the effectiveness of the Code. Time and time again it has become clear that there is a 'law of diminishing returns' involved in applying successive layers of regulation. For this reason we are very uneasy about the FCA's recent move to 'Build a regulatory framework for effective stewardship'.

Q8. Do you agree that signatories should be required to disclose their organisational purpose, values, strategy and culture?

Yes.

Q9. The draft 2019 Code incorporates stewardship beyond listed equity. Should the Provisions and Guidance be further expanded to better reflect other asset classes? If so, please indicate how?

At the UKSA / ShareSoc roundtable with the FRC on 21st February, it was suggested that there is more scope to apply stewardship to some types of investment than to others. There was a view that quoted equity funds and private equity investments should offer significantly more scope for stewardship principles to be applied than, say, corporate bond funds and that the guidance needed to recognise this.

However, this is a complex area. The FCA / FRC discussion paper (DP 19/1)[3] notes (paragraphs 4.20 - 4.25) that bond holders have (or should have) a very real interest in stewardship matters and that there is in practice plenty of scope for them to apply stewardship principles by engaging with the companies in which they invest.

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[3] Building a regulatory framework for effective stewardship – FCA / FRC Discussion paper - DP 19/1

The article in the FM section of the Financial Times[4] referred to in paragraph 2,1 above notes that more sophisticated financial markets now mean that it is easier for institutional investors to hedge the riskiness of their equity stake, potentially weakening the alignment with wealth creation, adding

> 'The capital structure of companies is morphing, reliance on equity issuance is declining while expectations about the impact of equity ownership on corporate behaviour continues to increase. The nature of financial markets has created an environment where the value of a company, as defined by its share price, is made up of a multitude of views many of which have no real interest in corporate success. Indeed it includes a community, in the form of short sellers, with a primary objective centred on corporate failure. This obviously does not lead to better stewardship'.

It also makes the point that alignment between equity ownership and the long-term health of the company has weakened. The nature of corporate liabilities is changing. What institutional investors actually own are the securities issued by a corporation, not its assets. It therefore makes sense for stewardship principles to be applied throughout the capital structure. The outstanding debt of some companies far exceeds their equity market capitalisation. When corporate failure occurs some bonds 'bailed-in' and exchanged for new shares. This being the case, it makes sense that the voice of bondholders is heard more loudly on matters of stewardship.

This prompts the view that there needs to be a more detailed debate about the scope for stewardship principles to be applied to different types of investment and how this alignment can best be achieved. Guidance on this will almost certainly be needed.

Q10. Does the proposed Provision 1 provide sufficient transparency to clients and beneficiaries as to how stewardship practices may differ across funds? Should signatories be expected to list the extent to which the stewardship approach applies against all funds?

As discussed in our response to Q9 above there needs to be further discussion about this. More guidance is certainly likely to be required. Key considerations underlying the guidance in this are:

- Who is going to read the information that signatories provide?
- What are the readers going to do with it? To what extent does it provide meaningful information for decision-making purposes?

This is a classic area in which examples in the Guidance of what 'good practice' looks like would be very helpful. Without this, every asset manager comes up with their own interpretation, each one 're-invents the wheel' in response, some come up with a good summary of differences but many fall back on writing boiler-plate.

It might be appropriate to assess guidance more fully in a post-implementation review.

Q11. Is it appropriate to ask asset owners and asset managers to disclose their investment beliefs? Will this provide meaningful insight to beneficiaries, clients or prospective clients?

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[4] Financial Times; FM supplement, Monday, 25th February – 'Business has to regain trust. Stewardship is the way to do it'.

The term ‘investment beliefs’ is somewhat ambiguous and vague. However, even at a superficial level it is difficult to see how asset managers can report meaningfully on Section 2 (Investment Approach) without commenting on their investment beliefs. Indeed, investment beliefs should form part of the context for reporting on the Investment Approach.

We suggest you add the words, “including asset allocation, stock picking and other beliefs” after “investment beliefs” in your drafting.

A number of funds earn significant revenue from lending stock out to others who may use the stock for short-selling. As indicated in the response to Q9 above, the interests of the short-sellers is focused primarily on corporate failure. Funds that lend out stock should therefore be obliged to disclose what stock they have lent out during the reporting period, the quantity of the stock and how much they have earned from doing this. This should be a requirement under Provisions 7 and 23 of the revised Code.

Q12. Does Section 3 set a sufficiently high expectation on signatories to monitor the agents that operate on their behalf?

No; the requirements seem only to be to:

- disclose which services they procure to support their stewardship;
- explain what actions they take to monitor service providers.

These requirements appear to set nothing more than the most basic of expectations.

The FCA CP/7 Proposals to Improve Stewardship Engagement will implement the stewardship provisions of the EU Shareholder Rights Directive into UK law and says:

‘In line with the text in the Directive, we propose to require asset managers to disclose:

> *• how their investment strategy and its implementation contributes to the medium to long-term performance of the assets of the asset owner or the fund*
>
> *• The following information:*
>
> - *the key material medium to long-term risks associated with the investments*
> - *portfolio composition*
> - *turnover*
> - *turnover costs*
> - *whether 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’*

We recommend this is amended as follows. The points highlighted in yellow in red font are additional to those on page 17 para 3.35 and Annex C (COBS) of FCA Consultation Paper CP19/7. Similar changes would be need to the drafting in Annex B of CP 19/7.

• how their investment strategy and its implementation contributes to the medium to long- term performance of the assets of the asset owner or the fund

• 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

If the FCA fail to agree with this recommendation, then the FRC should put this requirement into the Stewardship Code. However, the Stewardship Code is a comply or explain code, so many asset managers may choose not to comply.

Q13. Do you support the Code's use of 'collaborative engagement' rather than the term 'collective engagement'? If not, please explain your reasons.

Yes; as defined in the consultation document (para. 99) the shift of emphasis towards collaborative engagement seems entirely appropriate.

Ways to include individual investors (who own 29% of AIM companies and 12% of main market companies) should also be considered. Recent cases in which more formal collaboration between private investors and institutions would have been helpful include:

- Aviva's proposal in 2018 to redeem at par 200 million irredeemable preference shares with a high coupon;
- Unilever's proposal to simplify its corporate structure by moving its headquarters to Rotterdam and leaving the FTSE 100.

In both cases private investors and institutional investors baulked at the proposals and the companies were forced to think again. In both cases private and institutional investors worked independently of each other (almost all of the time). How much more effective might action have been if they had worked together?

There are many other situations, as well as specific areas if stewardship, in which it would be beneficial to encourage closer collaboration between private investors and institutional investors.

Another key area in which collaboration between asset managers would be beneficial is that of encouraging closer cooperation between UK and overseas asset managers over matters such as voting and influencing company boards on ESG matters. As mentioned in 2.3 above, some 54% of shares in UK listed companies (by value) are owned by overseas investors. Many of these will be fund managers. It would be attractive if UK fund managers could collaborate with their overseas counterparts where both have an interest in a company to ensure effective Stewardship. At a very basic private-investor level the UK Shareholders' Association works with its German counterpart (DSW) to attend AGM of UK companies in which the German shareholders have shares and to vote their shares as they instruct us. When voting against a resolution DSW always give us their reasons. This form of collaboration helps in ensuring a well-informed, considered and coherent approach to the way in which we and our German colleagues exercise our votes. It should not be difficult for asset managers to cooperate in a similar way and, given their resources, to cover wider stewardship issues than simply voting at AGMs.

The above collaboration should, of course, be reciprocal. Overseas and UK asset managers should work together to ensure better stewardship of overseas companies in which they are invested.

Q14. Should there be a mechanism for investors to escalate concerns about an investee company in confidence? What might the benefits be?

Yes; this is a potentially critical issue. It could be one of the acid tests of whether investee companies are taking their stewardship responsibilities seriously. The most obvious case recently would be Carillion in which it would have been vastly better if investors with concerns could have raised their worries with a third party at an early stage. Employees, pensioners, customers and suppliers, as well as investors, lost money and in some cases suffered threats to their future livelihoods thanks to the apparent sudden and catastrophic failure of Carillion. The fact that short sellers were circling the Company suggests that some people must have known that trouble was brewing. If appropriate channels and mechanisms are established so that concerns can be raised there can be no excuse for investors failing to raise these concerns.

We recognise that there are potential conflicts here. Nonetheless, whatever the conflicts, it cannot make sense in stewardship terms to have within a community of investors, short sellers, with a primary objective centred on corporate failure.

Q15. Should Section 5 be more specific about how signatories may demonstrate effective stewardship in asset classes other than listed equity?

Yes; this would be very helpful.

Q16. Do the Service Provider Principles and Provisions set sufficiently high expectations of practice and reporting? How else could the Code encourage accurate and high-quality service provision where issues currently exist?

We are unable to comment in detail on this, However, we agree with the principles expressed in para 104 of the consultation document, and specifically:

‘Although service providers, including proxy advisers and investment consultants, hold significant influence and have a role to play in supporting the effective functioning of the marketplace, it is ultimately the role of asset owners and asset managers to ensure they discharge their stewardship responsibilities, and, in doing so, hold to account those whose services they employ to advise or act on their behalf’.

We would be happy to meet to discuss our response in detail.

Yours faithfully,

Peter Parry – Policy Director – UK Shareholders’ Association

Cliff Weight – Policy Director - UK Individual Shareholders’ Society