February 2018

Response to FRC Stewardship Code Pre-Consultation Questions

Steering Group of The Purposeful Company

Submission context

This document sets out the response of the Steering Group of The Purposeful Company Taskforce to the pre-consultation questions on the Stewardship Code ('the Code'), issued by the Financial Reporting Council ('FRC') as part of its consultation on a revised UK Corporate Governance Code. These responses should be read in conjunction with our paper FRC Review of the Stewardship Code: Thoughts for Change ('Thoughts for Change') which sets out in detail our thoughts on a revised Stewardship Code.

In terms of terminology, in this paper we define:

- *Asset managers* as fund management companies (e.g. Fidelity).
- *Funds* as individual funds (e.g. Fidelity Special Situations).
- *Asset owners* or *savers* as ultimate owners (e.g. a university endowment or a retail investor).
- *Service providers* as investment consultants or proxy voting agencies (e.g. Aon Hewitt or ISS).

When talking about a generic actor in the investment chain, we use the term 'investment chain entity'.

Question responses

Question 17 – Should the Stewardship Code be more explicit about the expectations of those investing directly or indirectly and those advising them? Would separate codes or enhanced separate guidance for different categories of the investment chain help drive best practice?

We believe that it is essential that the Stewardship Code applies explicitly to all investment chain entities, including asset owners, asset managers, proxy advisors, and investment consultants. Creating a market for stewardship is likely to be significantly more effective than attempting to legislate stewardship through regulation, and requires the entire investment chain to take stewardship seriously. For example, asset managers may only perform the minimum level of stewardship required by regulation unless investment consultants and asset owners emphasise stewardship when awarding or recommending mandates. To improve stewardship quality, it is therefore important to consider how all participants in the chain act together to deliver stewardship. Simply improving standards in one part of the chain – for example asset managers – will deliver suboptimal results.

The current Code has, in our view, led to improvements in stewardship quality amongst asset managers, but it is overwhelmingly focused on that part of the investment chain. Only a minority of asset owners are signatories, and the Code does not focus on the aspects of stewardship most relevant to asset owners or service providers. We also believe that it is important that proxy advisors are brought under the remit of the Code more explicitly, and their role in the delivery of stewardship recognised. Evidence from the US and UK suggests that, for example, ISS voting recommendations have a causal impact on voting outcomes of 10% to 25% points, suggesting that some asset managers are outsourcing stewardship decisions to proxy advisors. Therefore, their operational models, analytical methods, and recommendation approaches should be subject to scrutiny and meaningful stewardship standards.

There is a view that service providers should not be elevated into having stewardship roles by including them under the Code. We understand this approach and are firm of the view that the Code should clearly and unambiguously attribute stewardship responsibilities to asset managers and asset owners. However, the reality of the market is that service providers of various types play a very material role in how stewardship is conducted. Therefore, including them within the Stewardship Code provides an opportunity to address in an integrated way their role in helping clients deliver stewardship.

The implementation of the EU Shareholder Rights Directive ('SRD') provides both an opportunity and risk. The SRD requires covered investment chain entities to make certain disclosures on a comply-or-explain basis and requires proxy advisors to follow a code of practice. The UK Government should set out in regulation that the Stewardship Code is the relevant code for all entities. This provides the opportunity to create a unified approach to encouraging better stewardship standards across the investment chain through an integrated Code, which can be a tool for continuous improvement in practices over time. The risk is that if this is not done, then different types of entity will apply different codes subject to reviews of different standards, which will substantially lessen the opportunity for driving up stewardship standards in an integrated way across the investment chain. In practice, the different codes would be reviewed according to varying criteria across different timeframes, and the quality of stewardship will depend on the weakest link in the chain. By creating an integrated Code as part of this review, the FRC will create the opportunity for the Government to use the SRD to encourage a step-change in stewardship quality, and a mechanism, through a single Code, for driving continuous improvement over time.

We would note that the decision to use an integrated Code is separate from the decision as to where regulatory oversight is located. Different regulators or legislation could all point to a single Code, overseen by the FRC. Therefore, code unification does not necessarily require unification of regulatory oversight, although there may be advantages to that.

Question 18 – Should the Stewardship Code focus on best practice expectations using a more traditional 'comply or explain' format? If so, are there any areas in which this would not be appropriate? How might we go about determining what best practice is?

As we describe in Thoughts for Change, there is a wide variety of investment styles, which implies different approaches to stewardship. For example, some may engage in activism, others may conduct detailed in-house research to guide their voting, and others still will analyse a firm's intangible assets and long-run growth prospects to base their retain versus sell decisions on these factors rather than short-term earnings. Therefore, care needs to be taken that use of "best practice expectations" does not have the unintended consequence of assuming a one-size-fits-all approach.

However, we do agree that the Code should move from an emphasis just on disclosure to the implementation of meaningful principles on an 'apply and explain' basis, supported by 'comply or explain' provisions. Those provisions should demonstrate that the principles are applied in a manner tailored to the entity's particular stewardship approach, rather than promoting a particular one-size-fits-all approach to stewardship.

We believe that a Code could have three principles, which have equal applicability across all investment chain entities regardless of their strategy.

Figure 1: Proposed principles

Principles	
Overarching principle	A signatory to the Code should be able to demonstrate how it implements, or help clients to implement an approach to investment that improves sustainable company performance.
A. Defining the approach to stewardship	An investment chain entity should clearly define the role of, and approach to, stewardship in meeting its purpose
B. Implementation of stewardship	An investment chain entity should establish governance, processes, and incentives to support its stated approach to stewardship, including identification and management of conflicts of interest
C. Reporting on the delivery of stewardship	An investment chain entity should clearly disclose its approach to stewardship and how it has been implemented in practice, including outcomes, in a manner that enables its clients and other stakeholders to judge the effectiveness of the approach in improving sustainable company performance.

The Code currently focuses on stewardship reporting. A revised Code should focus more stewardship delivery – on how stewardship is practically implemented within an organisation, through resourcing, integration into the investment process, aligning remuneration, and so on. This would help ensure that stewardship is not just a policy, but a practice.

Question 19 – Are there alternative ways in which the FRC could highlight best practice reporting other than the tiering exercise as it was undertaken in 2016?

Improving stewardship standards substantially requires the development of market demand for stewardship. This requires reform that goes beyond the Code, but the Code can play an important part of highlighting to all investment chain entities their stewardship responsibilities. Moreover, reporting provides an important mechanism to enable investment chain entities to hold each other to account. The focus of the FRC's efforts in relation to reporting should, therefore, be to encourage reporting that facilitates a market for stewardship.

The FRC could make three contributions to support high-quality stewardship:

- Reviewing stewardship reports for coverage of required information, including a qualitative component linked to how well the reports demonstrate how the firm is fulfilling its stated stewardship approach. This could include random checking of fund documentation (see response to Q31).
- Producing an annual reporting review, including case studies of best practice stewardship reporting to provide aspirational examples.
- Developing frameworks for describing stewardship and supporting terminology for stewardship types and activities. This could be developed into standardised reporting templates enabling firms to describe their approach to stewardship in a way that is comparable and consistent across entities, to support market transparency for their clients and beneficiaries.

The FRC could consider focusing their review activity in two ways:

- Adopting a proportionality regime that tiers asset owners, asset managers, and service providers by reference to size and/or market share. Signatories in the highest tier could be subject to more pro-active review of reporting quality by the FRC.
- Rather than tiering all firms, the FRC could create a Tier status that firms must apply for, subject to fulfilling certain requirements in relation to transparency, quality of reporting, and independent review of the rigour with which stewardship has been embedded. Such an approach would lead to these high tiers having to be earned through exceptional practice, rather than being a default that is only lost through red flags. The FRC should also continue to emphasise that the Tier status is only certification of stewardship reporting, rather than stewardship delivery. There is anecdotal evidence that asset owners and investment consultants believe they can fulfil their stewardship responsibilities by simply selecting asset managers in Tier 1.

The FRC could also develop a series of market participant studies on stewardship quality. This could involve asking participants in the investment chain to assess each other on a series of engagement and stewardship quality criteria. Such '360-degree feedback', if carefully conducted, could provide a way to help identify issues and drive up standards across the investment chain. We note that there are risks with this approach. For example, corporate views of what constitutes good stewardship may differ from approaches that are in the interests of beneficiaries. Companies may rate dissenting investors as poor stewards, even if the investors have formed their opinion after extensive discussions with companies. Alternatively, asset managers may seek to deflect blame for stewardship deficiencies onto service providers. Therefore, we would recommend any such activity be carried out in a spirit of learning and improvement, which may in the first instance involve the FRC publishing general findings, while sharing specific findings with firms. This would also provide a basis on which the FRC could challenge firms as to their implementation of stewardship. Publication of findings could be considered by the FRC once market confidence had been built in the approach.

Question 20 – Are there elements of the revised UK Corporate Governance Code that we should mirror in the Stewardship Code?

Four aspects of the revised UK Corporate Governance Code could be reflected in the Stewardship Code:

- The principles-based approach, with an emphasis on explaining how the principles have been applied, with less emphasis on a tick-box list of comply-or-explain provisions.
- A strong focus on aligning corporate governance with purpose, strategy and culture.
- Increased emphasis on broader stakeholder considerations.
- Alignment of remuneration with strategy and culture, in particular, in relation to stewardship and investment approach.

Of course, those asset managers that are UK listed entities will be subject to the UK Corporate Governance Code directly, as well as potentially being signatories to the Stewardship Code.

We have already described the importance of an approach based on the delivery of stewardship, which emphasises the need for firms to set out clearly their approach to stewardship and how their organisation, governance, and processes align with this. This is vital for the market for stewardship to operate effectively. It is easy to see how principles in the revised UK Corporate Governance Code under Section 1 – Leadership and purpose, and Section 2 – Remuneration, could be very relevant in this context, although they would require adaptation to be applicable to the Stewardship Code. Moreover, the way in which the Board Effectiveness Guidance has developed as a handbook to implementing the Code could also be a useful precedent for a similar document to help various investment chain entities think through how they could meet their Stewardship Code responsibilities.

Question 21 – How could an investor's role in building a company's long-term success be further encouraged through the Stewardship Code?

We believe that it is key for investment chain entities to understand that it is in their own interest to build up a company's long-term success. Such an understanding will ensure that entities undertake stewardship through voluntary commitment, rather than compliance to a code. Yet the Code still has a major part to play in generating this commitment, through requiring entities to explain the role stewardship plays in their investment approach and to demonstrate how this is practically achieved. In particular, we are suggesting an overarching principle that a signatory to the Code should demonstrate how it implements, or help clients to implement an approach to investment that improves sustainable company performance. We are also suggesting a reorientation of the Code away from reporting of principles to demonstrating how these principles are applied, using a combination of apply-and-explain and comply-or explain. This, in turn, encourages entities to think through, and be transparent about their approach, and in this way create the opportunity for all investment chain entities to hold each other to account. This aim will also be supported by tailoring the Code to be relevant to the various types of investment chain entity.

In this context, we think it is helpful for firms to be encouraged to describe how they take longer-term factors, such as ESG criteria or intangible assets, into account in their investment approach. However, we do not believe that the Code should pre-suppose which factors asset owners or asset managers take into account, as this will be specific to the purpose of individual entities.

While generating a market demand for stewardship is the surest way to improve stewardship practice, aligning incentives is also very important. Even in an environment where the benefits of stewardship were understood, and high standards of stewardship were demanded, misaligned incentives could undermine stewardship – in particular, if they were based on short-term performance. Incentives operate both at the individual level, in terms of asset manager or asset owner pay, but also at the institutional level, in terms of fee arrangements for asset managers and service providers. We are proposing that alignment of incentives to stated approach to stewardship should be included as a requirement in the Code, and the FRC could helpfully develop guidance in this area to complement existing regulatory requirements under the EU Directives UCITSV and AIFMD.

Question 22 – Would it be appropriate to incorporate 'wider stakeholders' into the areas of suggested focus for monitoring and engagement by investors? Should the Stewardship Code more explicitly refer to ESG factors and broader social impact? If so, how should these be integrated and are there any specific areas of focus that should be addressed?

As set out in our approach to Q20, we believe it is appropriate for shareholders to set expectations for how they expect their investee companies to take into account wider stakeholder considerations as part of fulfilling their section 172 obligations, and their view on how this contributes to business sustainability. This is, in part, because considering other stakeholders is important in the creation of long-term shareholder value. However, it should be down to individual investors how they set these expectations. The stakeholder considerations that are material will likely differ from company to company, and even within the same company over time.

Given the variety of stewardship approaches and investment styles, it would be dangerous to be prescriptive. For example, a requirement to use ESG factors in investment decision-making may result in tick-box usage of ESG-screening tools, rather than meaningful engagement.

Question 23 – How can the Stewardship Code encourage reporting on the way in which stewardship activities have been carried out? Are there ways in which the FRC or others could encourage this reporting, even if the encouragement falls outside of the Stewardship Code?

The principles should make it clear that reporting needs to explain how stewardship has been carried out and how the firm's governance and processes, including incentives, support its approach to stewardship. The Stewardship Code could provide reporting guidance to this effect. Our response to Q19 sets out ways in which the FRC could encourage this through its tiering and review activities, as well as through the development of reporting frameworks.

Given the range of investment styles, and hence stewardship approaches that may be adopted by different funds operated by a single asset manager, there is a danger that stewardship reporting at the asset manager level become generic or boiler plate. Asset owners buy funds, not asset managers. As we set out in Thoughts for Change, while overall stewardship reporting should continue to operate at the asset manager level, there should also be appropriate reporting at the fund level to show how stewardship supports that fund's investment objectives. This will create transparency to asset owners at the fund level. To minimise the reporting burden, the fund's stewardship approach can cross-reference the asset manager's overall approach.

We note that implementation of the Shareholder Rights Directive also creates the opportunity to create a regulatory underpinning to Code reporting requirements, and we recommend liaison with Department for Business, Energy & Industrial Strategy (BEIS) to try to ensure that the Code can form the single point where requirements for all investment chain entities are captured.

Question 24 – How could the Stewardship Code take account of some investors' wider view of responsible investment?

We believe that signatories to the Code should consider their stewardship approach across asset classes. For example, debt investors engage with companies, albeit without the voting rights of shareholders. Nonetheless, signatories to the Stewardship Code should consider how their stewardship responsibilities apply to debt holdings/funds. This is more complicated for engagement since debt investors benefit from downside protection rather than growth, innovation, and investment in intangible assets. However, a unified approach may be easier for monitoring – for example, consideration of ESG criteria may be applicable to both debt and equity investments. Multi-asset entities should consider their stewardship responsibilities in aggregate, in particular, how they apply for debt holdings and the extent to which they are similar to or different from their application to equity holdings.

Question 25 – Are there elements of international stewardship codes that should be included in the Stewardship Code?

We have not undertaken a comprehensive review of international stewardship codes. However, the Principles 1 and 7 of the Canadian Coalition for Good Governance stewardship code and Principles 1 and 6 of the International Corporate Governance Network (ICGN) stewardship code both contain useful themes in relation to:

- Establishing a stewardship approach;
- Aligning the firm's governance and processes (including remuneration) to the stated stewardship approach; and
- Encouraging a long-term approach to sustainable investment.

The ICGN principles also contain a section on the ecosystem of stewardship, which seeks to draw out some of the connections between different entities within the investment chain. We believe that this connectivity is an important part of any revised Code, and believe it should be developed to a greater level of specificity, as set out in Thoughts for Change.

As noted in the FRC's consultation document, the consultation on the Dutch Stewardship Code includes the use of stock lending. In Thoughts for Change, we recommend that entities disclose their stock lending policy. In The Purposeful Company Policy Report[1], we recommended that voting with borrowed stock be restricted to blockholders. However, we would suggest that such a provision would be better implemented through regulation than through the Code, else signatories felt they were being put at a commercial disadvantage.

Question 26 – What role should independent assurance play in revisions to the Stewardship Code? Are there ways in which independent assurance could be made more useful and effective?

Large firms subject to financial services banking regulation are required to undertake an independent review of their compliance with the regulation. The Stewardship Code could include a principle relating to the independent review. This could involve the use of internal audit or an independent third party periodically to review application of the firm's approach to stewardship and reporting, together with a statement as to when such a review was last undertaken and its findings. This could also be framed in a way similar to board effectiveness reviews under the UK Corporate Governance Code. We would suggest application of a proportionality threshold for this requirement, based for example on funds under management. As highlighted in our response to Q19, the FRC could adopt a highest Tier of signatory that operated by application – firms applying for the highest Tier would be required to undertake an independent evaluation of their implementation of stewardship and to report on this.

Question 27 – Would it be appropriate for the Stewardship Code to support disclosure of the approach to directed voting in pooled funds?

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[1] http://www.biginnovationcentre.com/media/uploads/pdf/TPC_Policy%20Report.pdf

Yes. In general, the Stewardship Code should support initiatives to provide transparency on voting approaches, to enable all investment chain entities fully to understand how stewardship obligations are being fulfilled in voting.

Question 28 – Should board and executive pipeline diversity be included as an explicit expectation of investor engagement?

and

Question 29 – Should the Stewardship Code explicitly request that investors give consideration to company performance and reporting on adapting to climate change?

While there is evidence that considering other stakeholders ultimately improves long-run shareholder value, the stakeholder considerations that are material will differ significantly from company to company. As a result, we are cautious about mandating within the Code that entities include particular factors, such as diversity and climate change, in their approach. This runs the risk of assuming a one-size-fits-all approach to stewardship and could encourage a tick-box approach to disclosure. The emphasis should be on requiring entities to define what stewardship means for them and then to report against how they deliver it.

Indeed, if the Code revision were seen as a way to pursue wider public policy interests in a way that undermines saver interests (because they advocate the consideration of factors that reduce long-term returns in certain settings), this may be fatal to its credibility. If a majority of asset managers felt that measures were being imposed through the Code that were damaging to their interests, then the Code would immediately lose credibility. A situation where it became the norm for asset managers not to comply with several Code provisions would undermine its legitimacy. This would suggest that very specific quasi-regulatory provisions where there is neither evidence for their widespread efficacy nor asset manager or saver support should not be implemented via the Code.

However, as set out in response to Q19, there may be scope for developing a standards taxonomy of stewardship approaches and considerations, which could lead to standardized templates outlining stewardship approaches. If developed with care, and in a way that retains flexibility, such templates and taxonomy could be helpful to clients in assessing the approach to stewardship of different entities. Aspects such as diversity and ESG could be relevant within those taxonomies.

Question 30 – Should signatories to the Stewardship Code define the purpose of stewardship with respect to the role of their organisation and specific investment or other activities?

Yes. This is essential. As noted in our response to Q17, every investment chain entity should be required to define their approach to stewardship, organise in a way that supports that approach to stewardship, and report on how they have delivered stewardship in line with their stated approach. Starting first with purpose, and defining stewardship in the context of purpose, will help ensure that stewardship is undertaken out of intrinsic commitment rather than regulatory compliance.

Note that the word 'purpose' does not refer to any moral obligation, although a fund could have social or ethical objectives. Purpose reflects a broader notion than a fund's 'objective', which typically contains only quantitative dimensions and/or is generic (e.g. 'to generate long-term capital appreciation') –

instead, purpose will describe how a fund intends to generate long-term capital appreciation and explain the role, if any, that stewardship plays in this.

A sample statement of purpose, and approach to stewardship, follow below. This aims to show how an approach to stewardship can be tightly linked to purpose, yet remain separate and so there is value in defining both:

Purpose: "To create long-term real returns over the long term with lower than average volatility by investing in companies with high-quality intangible assets generating high return on capital."

Approach to stewardship: "We believe that focus on short-term profit measures can discourage revenue investments (such as marketing, people, and innovation) and that drive long-term returns. We, therefore, focus on investing in companies with a strong record of sustaining high returns on capital with organic growth, through maintaining strong brands and other hard-to-replicate intangible assets. We engage actively with management teams to encourage focus on building intangible assets through revenue as well as capital investments, with a focus on organic rather than inorganic growth. We will exit investments where these principles cease to be followed and engagement with management fails to produce change."

Question 31 – Should the Stewardship Code require asset managers to disclose a fund's purpose and its specific approach to stewardship, and report against these approaches at a fund level? How might this best be achieved?

Yes. Different funds have different objectives and as a result, stewardship may play a very different role across funds within the same asset manager. Without appropriate transparency at the fund level, it will be very difficult for clients to hold funds to account on their stewardship obligations. However, to minimise the reporting burden, it should still be the asset manager that is the Stewardship Code signatory. The fund level documentation should then briefly set out particular aspects of how the firm-wide approach is applied at the fund level and any deviations from the firm-wide approach and processes.

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February 2018

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