

Catherine Horton  
Financial Reporting Council  
8<sup>th</sup> Floor  
125 London Wall  
London  
EC2Y 5AS

**The Investment Association**

Camomile Court, 23 Camomile Street,  
London, EC3A 7LL

T +44 20 7831 0898

E [enquiries@theia.org](mailto:enquiries@theia.org)

W [theinvestmentassociation.org](http://theinvestmentassociation.org)

Twitter @InvAssoc

**Date: 28<sup>th</sup> February 2018**

Dear Catherine,

**RE: Consultation on Proposed Revisions to the UK Corporate Governance Code**

The Investment Association welcomes the opportunity to provide input to your consultation on the UK Corporate Governance Code and the Stewardship Code. The Investment Association is the trade body that represents UK investment managers. Our 250 members collectively manage over £6.9trillion on behalf of clients in the UK and around the world.

The Investment Association is supportive of the move to update the Code, to make sure that it reflects investor expectations of companies and continues to drive high standards of corporate governance in the UK.

Over the last 25 years, the UK Corporate Governance Code has been the bedrock of the UK corporate governance regime. For the last 18 months, the debate on corporate governance reform has rightly focussed on a number of areas where the current regime can evolve and improve, and we see this as an important opportunity to improve the Code so that it supports market best practice, and draws attention to areas that require renewed focus in corporate governance.

We have provided detailed feedback to the questions in the consultation in Annex 1, however, our key positions are as follows:

- **We are supportive of the principles based approach to corporate governance.** The Investment Association believes that the Code must remain high-level to be most effective. It must not be too prescriptive, otherwise it risks driving compliance-led behaviour that could be counterproductive. We recognise that the FRC has refocused on the Principles, to ensure that companies better report on how they have applied the Principles of the Code to their shareholders.
- **“Comply-or-explain” must be retained.** It is important to retain and strengthen the “comply or explain” approach, so that companies do feel free to explain if necessary. Investors want such explanations to be well-reasoned, clearly linked to the business strategy of the company and outline how risks of diverging from the Code have been minimised. Our members are committed to considering such explanations in the context of the individual circumstances of the company. The Code should not operate on a strict compliance basis and it is important that companies feel that they can explain where they deviate from the Code.



- **Stakeholder Engagement:** We are supportive of the greater focus on stakeholder engagement in the Code, and we are pleased that the FRC has supported the IA's joint guidance with ICSA: The Governance Institute. We are, however, concerned that the revised Code focuses too narrowly on workforce engagement, and moves away from the established duties of directors as set out in law, to make decisions for the benefit of all members while taking account of the long-term and other stakeholders. The Code needs to better reflect Directors' Duties under s.172 of the Companies Act, and the Code needs to address the wider governance mechanisms needed to incorporate the full range of material stakeholder views into board decision-making. Specifically, the revised Code should:
  - Complement existing Directors' Duties and the unitary board structure;
  - Recognise that stakeholders are broader than the workforce and engagement should focus on material stakeholders;
  - Recognise that the suggested engagement mechanisms cannot work in isolation; and
  - Recognise that there is a distinction between Board engagement and Board understanding of the views of stakeholders.
- **Companies responding to shareholder dissent:** We are pleased that the FRC is proposing changes to the Code that aim to improve the provisions on how companies should respond to significant shareholder dissent. We believe that 20% is the appropriate level and welcome the requirement for companies to respond publicly within 6 months of the AGM outlining the actions they have taken in response to the shareholder vote. This directly aligns with and supports the aims of the IA's [Public Register](#), which was launched in December to provide information on significant votes against, and to provide a platform for companies to respond to investor concerns.
- **Director Independence and Board Composition:** We believe that changing the presumption of independence such that directors are automatically deemed non-independent if they do not meet the relevant code provisions is helpful. This will mean that companies focus more on explaining why directors have the right skills for the board.
- **Independence of the Chair:** We note the change to the designation of the chair's independence, from independence only being assessed on appointment, to being considered on an ongoing basis. Investors have a range of views on this issue, and we believe that this issue needs to be considered further to avoid unintended consequences.
- **Stewardship Code:** The UK is recognised as a leader internationally on stewardship, and we welcome the opportunity to help to make sure the Stewardship Code continues to support the development of stewardship. There are certainly areas of the Code which can be improved to reflect the evolution of stewardship since the inception of the Code. However, the review and update of the Stewardship Code should take place within the context of a clear purpose for the Code, and a clear definition of what stewardship is.

In order to improve stewardship in the UK, we believe that, as well as looking at the Code, we also need to focus on stewardship activities and the environment for stewardship. Whilst the Code needs to be updated to reflect market developments and best practice, there is also a need to [create a better market for stewardship](#).

In our response to the questions below, we have suggested that this could be done by:

- Improving public reporting by asset managers on how they have carried out their stewardship activities and fulfilled their stewardship policies; and
- Developing more demanding and discerning asset owners in order to develop market practice and increase competition in the industry on stewardship.



We hope this feedback is helpful. Please do not hesitate to contact me if you wish to discuss any of these points further.

Yours sincerely,

**Andrew Ninian**

**Director, Stewardship & Corporate Governance**

# ANNEX I

## RESPONSES TO QUESTIONS

### SECTION 1 – UK CORPORATE GOVERNANCE CODE AND GUIDANCE ON BOARD EFFECTIVENESS QUESTIONS

#### **1. Do you have any concerns in relation to the proposed Code application date?**

Whilst we recognise that implementing a new Code for year ends any earlier than January 2019 may not present a sufficient timeframe for companies to respond to the proposed changes to the Code, it is important to recognise that this means that companies will not be required to report against the new Code until Q2 2020.

This delay in application should be viewed in the wider context that surrounds this consultation and debate on corporate governance reform. Corporate governance in the UK has recently, and will continue to be, under intense political and media scrutiny. Serious questions have been asked about whether the system is up to standard, and whether the Code goes far enough to address public trust in business.

The Investment Association believes that corporate governance works best when it is a market based initiative, but we are very cognisant that the credibility of this approach as opposed to regulation is dependent on the success of the Code in addressing the issues identified. We are concerned that the delay may cause some to say that the market based approach is not addressing the problems and call for a strict, regulatory approach to corporate governance.

We hope, therefore, that the FRC will encourage companies to adopt and report against the new Code earlier than this, otherwise there will be a significant time lag before the effects of the 2017 Corporate Governance Reforms are felt.

#### **2. Do you have any comments on the revised Guidance?**

The role of the Board Effectiveness Guidance should be to complement the high-level governance principles set out in the Corporate Governance Code with further details on best practice approaches. We broadly agree that the revised Guidance continues to fulfil this role, however, there are some provisions that have been moved from the Code to the Guidance that we would like to highlight.

##### Role of the Senior Independent Director

In the current Code under A.4.1., the senior independent director is identified as having a responsibility to “be available to shareholders if they have concerns which contact through the normal channels of chairman, chief executive directors has failed to resolve or for which such contact is inappropriate”. This provision is important, as it sets out the role of the senior independent director as a safety valve for investors, when other governance channels have failed.

We are concerned that this role has not been adequately reflected in Provision 12, where the senior independent director is described as “an intermediary...for shareholders”, and that it is too significant to only be reflected in paragraph 57 of the revised Board Effectiveness Guidance. We would therefore ask that Provision 12 is

expanded to reflect the backstop role of the senior independent director as a point of contact for investors, and retains the detail of the original wording.



#### Relations with Shareholders

Some of the original Section E has been moved to the Guidance, however we note that E.2.4, which reminded companies that the notice of AGM and related papers should be sent at least 20 working days before the meeting, has been removed. Although this requirement largely duplicates company law (CA.2006 s.207A), the fact that the Corporate Governance Code specified 20 working days rather than 20 days was a helpful provision for investors, and insured that they receive timely information before general meetings. We would ask that this is restored in the "Relations with Shareholders" section of the Board Effectiveness Guidance.

#### Board Composition, Succession and Evaluation

Paragraph 78 of the revised Guidance notes that the impact of the commitments of the Chair should be explained in the annual report. Given that that investors look at the external commitments of directors and the time they have to devote their board duties, we would suggest that this is extended to all non-executive directors, not just the Chair.

#### Board Meeting Frequency

The current version of the Code notes that the Board should meet sufficiently regularly to discharge its duties (A.1.1.). This could be reflected more fully in the Board Effectiveness Guidance.

### **3. Do you agree that the proposed methods in Provision 3 are sufficient to achieve meaningful engagement?**

In answer to this question we have addressed both Provision 3 in relation to workforce engagement, and the entirety of "Section 1 – Leadership and Purpose" in relation to stakeholder engagement more broadly. Workforce engagement as mentioned in Provision 3 is just one part of stakeholder engagement and the exercise of Directors' Duties as set out in section 172 of the Companies Act.

Investors want companies to take decisions which will generate the best long-term value to their shareholders. To make such decisions, boards need to hear and take account of the views of their stakeholders. Failure to do so could impact on the future success of the company.

The Investment Association believes that current Directors' Duties are appropriately drafted in law and that they support the needs of investors. They are sufficiently balanced and already require directors to take into account the interests of employees, customers, suppliers, the community, and the environment. However, we continue to argue that the implementation of directors' duties could be improved.

We are therefore supportive of the increased focus in the revised Code on the importance of boards understanding and taking into account the views of their stakeholders in their long-term decision-making.

In September 2017 the IA published a joint report with ICSA: The Governance Institute "[The Stakeholder Voice in Board Decision Making](#)", to provide industry-led guidance to help boards understand and weigh up the interests of their key stakeholders. We are pleased that the FRC has supported the guidance and endorsed it in the revised Board Effectiveness Guidance.

The IA/ICSA joint guidance on stakeholder engagement found that:

- Boards need to go through a formal process of identifying their material stakeholders and should keep this updated on a regular basis;
- Boards should decide how the board composition could better reflect the views and interests of stakeholders;
- Boards should ensure that they have appropriate mechanisms to understand the views of their stakeholders, and should decide which stakeholders they need to engage with directly, and which they receive information from the management on stakeholder engagement;
- The Chair is responsible for ensuring that decision-making of the Board incorporates the views of stakeholders; and
- Boards must report on both the process they undertake for considering the views of their stakeholders, and the impact of these engagements on the Board decisions.



These points are crucial to board-stakeholder engagement, and should be reflected more fully in the revised Code. The revised Code in its current form focuses on specific examples of stakeholder engagement mechanisms, but we believe that, to effectively address the underlying concerns, the revised Code needs to more fully address the wider governance mechanisms needed to incorporate the full range of stakeholder views.

In particular, we would make the following comments:

- Directors' duties as defined in s.172 of the Companies Act need to be more fully recognised in the revised Code. The primary duty of directors is to promote the success of the company for the benefit of its members (the shareholders) as a whole. While carrying out this duty they must have regard for the long-term and stakeholders, such as suppliers, customers, community and the environment, among others.

If stakeholder representatives are appointed to a board, they must fulfil the role of a director and therefore refer to the views of all stakeholders, not just a particular representative group. Therefore, this representative must be selected on their ability to fulfil the role as director of the company first and foremost, rather than as a representative, as this would disrupt the unitary board model. All directors owe the same duties to the company, including the duty to exercise independent judgement.

We note that the current version of the Code includes a specific reference in the footnotes to sections 170 to 177 of the Companies Act 2006 in Section A. We believe it would be helpful to maintain this reference in the revised Code.

Principle A's wording states that the board's function is "*to promote the long-term sustainable success of the company, generate value for shareholders and **contribute to wider society***". Clearly, companies do not operate in a vacuum and companies who do not contribute to society are unlikely to be successful in the long-term. However, we are cautious that the responsibilities of directors individually and therefore the function of the board (as a collection of directors) is one that is set out in law in s.172 of the Companies Act, and the Code should complement and support and not contradict this. We are concerned that the wording of the Code does not fully acknowledge shareholder primacy reflected in s.172, as it puts contributions to society on the same level as generating value for shareholders.



In addition, we feel that the use of the term “wider society” in Principle A is imprecise. All material stakeholders will form a part of wider society, but the use of this term may present a broader and less useful focus than on those stakeholders who are most material to a business.

It has been suggested to us that ending Principle A after “success of the company” could help to make this statement clearer and so as not cause confusion. As stated above, the footnote reference to s.170-177 will then link this to directors’ duties.

- The revised Code must support the UK’s unitary board system. The UK has a unitary board system whereby directors all owe the same duties to all stakeholders as set out in section 172.

We believe that Provision 3 should highlight that whatever mechanism boards decide to implement, this mechanism should work within the context of the unitary board structure, and not take away from the duties that all directors on the Board owe to shareholders and other stakeholders, and the collective responsibility of the Board as a whole.

- The revised Code should recognise that stakeholder engagement goes beyond workforce engagement. The focus on the workforce in Provision 3 also risks neglecting the importance of Board engagement with other types of stakeholders – including customers, suppliers and the community. The IA/ICSA Guidance recognised that companies are likely to have a wide range of stakeholders beyond their workforce, and that these stakeholder groups will often vary from company to company. The Corporate Governance Code should recognise that Boards must start by identifying their different stakeholder groups and then go on to develop engagement mechanisms for those stakeholder groups which are material. This may typically include groups such as suppliers, customers, providers of financial capital and communities.

For clarity, and to indicate that the workforce is a subset of stakeholders as a whole, the order of Provisions 3 and 4 could be reversed.

- The revised Code should recognise that companies must identify their most **material** stakeholders. Companies will have a range of different stakeholders, dependent on their business model. While many will have groups in common such as employees and customers, others will vary. Investors want companies to identify the stakeholders that are material to the long-term success of their business, and engage with these groups. It is not possible or desirable for companies to try to engage with an abstract list of “stakeholders”; a company’s stakeholders must be specific to them and must be those groups that are most material to their business in the long-term.

We would suggest that Provision 4 in particular is updated to reflect the fact that companies must focus on their material stakeholders.

- The revised Code should recognise that boards should have the flexibility to choose the right engagement mechanisms to suit their business. The three engagement mechanisms set out in Provision 3, while representing common options for Boards to use to engage with their workforce, may not be the only three options that Boards may want to use. As we set out in the IA/ICSA Guidance, Boards should design engagement mechanisms with consideration for what would be the most effective and convenient for the stakeholders.



We hope that Provision 3 is supported by the **comply-or-explain** approach, such that Boards can have the flexibility to choose the right engagement mechanism to fit their company and workforce, which may be an alternative to the three suggested mechanisms. A set of options that is too rigidly set out may hinder Boards taking the time to choose the mechanism that is right for them. We would suggest that the Code makes clear that companies can go beyond the options set out in Provision 3.

- The revised Code should reflect the distinction between board understanding of stakeholder views and Board having direct engagement with the stakeholders. The priority for the board is that they take into account the views of their material stakeholders. As the ICSA/IA Guidance points out, this may or may not involve board members engaging directly with stakeholders (although in some cases the board may judge this to be the right approach), instead it may mean that they incorporate the information gathered by engagement carried out by executives or the company more broadly into their board decision-making.

This distinction is important: it is not the role of the Board to engage with all of the material stakeholders of the company, but it is their role to consider the views of these stakeholders as part of their long-term decision-making.

- Engagement mechanisms cannot work in isolation. It is not sufficient for companies to merely set up one of the mechanisms for engagement suggested by the Code. These processes must also have the appropriate feed-in mechanisms from the stakeholders themselves. For example, if the Company chooses to use a designated NED, there needs to be an appropriate mechanism or process for the designated NED to hear from the workforce, so that they can reflect the views of the workforce into the Board discussion. Likewise an employee representative is unlikely to be able to provide views and perspectives of all employees globally. An employee director will have to have some process to understand the views of the wider workforce.
- Board discussions need to incorporate the views of stakeholders. The engagement mechanisms must be supported by an appropriate process to ensure that the Board actually reflect the views of their stakeholder discussions into Board decision-making. The Code should stress that Boards must have time to review the outcomes of the stakeholder engagement. Setting up these mechanisms in isolation from such a process will fail to have an impact on board decision-making. For example, appointing a designated non-executive director with responsibility for workforce engagement is a token gesture unless the designated NED has an appropriate way of reporting back to the Board.
- Use of "workforce" terminology in the revised Code: We note that the revised Code makes reference to the "workforce" rather than employees. We recognise that this terminology takes account of how employment practices have evolved in recent years. However, the FRC must ensure that this term is widely understood so that it does not cause confusion for companies and boards on the extent of their responsibilities. Boards may need to conduct an exercise to consider the extent of their workforce population, and understand how much influence they have over some elements of their workforce, particularly contractors. They also should disclose this assessment of the constitution of their workforce, for their shareholders to review.

#### **4. Do you consider that we should include more specific reference to the UN SDGs or other NGO principles, either in the Guidance?**



ESG risks can be material to the long-term value of companies in which IA members invest, and investors are taking these risks into consideration in their investment and stewardship decisions. We think that the Code should acknowledge that boards should be identifying and addressing risks to the business where they are material to the company's long term value. We believe that Principle B should reflect this, by referencing the Board's responsibility for overseeing the assessment of **any material** risks, which may include ESG risks.

In identifying and reporting on these risks, there are a range of internationally recognised frameworks and principles that can be a helpful resource for companies. However, we do not believe that the Corporate Governance Code, as a framework for governance of companies, is the most appropriate place to include a reference to such frameworks.

The Sustainable Development Goals (SDGs) are becoming an important framework with which a range of company stakeholders, including shareholders, can assess the company's impact on society. Some IA members are using the SDGs to assess companies, and as such, we would support further encouragement for companies to report against this framework. However, as we have stated above, the SDGs should be recommended to companies through other means, rather than through the Corporate Governance Code.

Instead, it may be appropriate for the Government to consider if there is need for a reporting requirement against the SDGs in the Strategic Report, or to reference it as a possible framework for reference in the Board Effectiveness Guidance.

#### **5. Do you agree that 20 per cent is 'significant' and that an update should be published no later than six months after the vote?**

We support the continuation of the provision in the Code that companies must respond to significant votes against, and welcome the strengthening of this provision.

In December 2017, the IA launched the [Public Register](#), an aggregated list of publicly available information regarding meetings of companies in the FTSE All-Share who have received significant shareholder opposition to proposed resolutions or have withdrawn a resolution prior to the shareholder vote. The IA decided to create the Register as investors have found that the current provisions of the Corporate Governance Code that ask companies to acknowledge significant votes against and set out what actions the Board intends to take as a result of the significant vote against were not working in practice. This was supported by evidence collected by the FRC that showed that only 50% of companies acknowledge significant dissent in their AGM results announcement.

The purpose of the Public Register is to highlight companies who receive a high vote against or withdraw a resolution, and to understand the process used by those companies to identify and address the concerns of their shareholders. As we have highlighted above, the current provisions of the Code have not been well implemented, and the IA wanted to find another way to drive responses to significant dissent.

Our members have found that even the 50% of companies who include a statement in their AGM results to acknowledge dissent may only pay lip service to seeking out the reasons for the shareholder dissent. They will say that they intend to engage with

shareholders but often shareholders do not feel that this happens in practice, and that the engagement does not result in meaningful actions to address the underlying concerns of members.



We have included in the Public Register the opportunity for companies to make a further announcement on what they have done to understand shareholder views and take them into account since the vote. The Public Register displays what response the company has made at the time of the meeting (as set out by E.2.2. of the current Corporate Governance Code), but also includes a link to any further announcement(s) the company has made in response to the dissent, including the views received from shareholders and what the company has or proposes to do in response.

We are pleased that the FRC is proposing changes to the Code that aim to improve the provisions on shareholder engagement on significant dissent. It is helpful to affirm investors' expectations of companies within the Code. We believe that the inclusion of the six month update provision in the revised Code would align well with the aims of the Public Register, and the time frame would help to encourage companies to make an additional announcement regarding their further engagement with shareholders. Six months is an appropriate period for companies to respond, as it gives sufficient time for companies to understand the view of investors, and to comment on future actions that they may take in relation to the following year's meeting.

It would be helpful if the Code is explicit on what is expected from a company update. We expect that such an update would include an overview of the views heard from the company's shareholders on the reasons for the voting result, and the outcome of the actions taken or to be taken by the Board subsequently to the vote in question.

20 per cent is acknowledged as the market standard for significant dissent, and has been codified in the [GC100 and Investor Group Guidelines](#) since 2013. The Public Register uses the 20 per cent threshold, and we support the explicit inclusion of this threshold in the revised Corporate Governance Code. We would, however, note that the Public Register lists companies that have a 20 per cent vote against **the Board recommendation** for that vote, to account for requisitioned resolutions which do not have Board support.

The Public Register allows companies to present the context and reason for significant votes, and any actions they intend to take. We would therefore stress that the inclusion of a 20 per cent threshold should not be seen by companies as a barrier to innovation or different approaches to governance, as both the Code and the Public Register provide for companies to be able to explain why their course of action is right for the individual business, and how shareholder voting relates to this view. We do not think that this threshold should be cited as a reason to stifle or shy away from innovation.

**6. Do you agree with the removal of the exemption for companies below the FTSE 350 to have an independent board evaluation every three years? If not, please provide information relating to the potential costs and other burdens involved.**

We are generally supportive of the exemption regarding board evaluations and other exemptions for smaller companies being removed to reflect increasingly high expectations of corporate governance for companies right across the market.

In particular, board evaluations, when executed well, provide an important mechanism in ensuring board effectiveness. Many boards take their board evaluations very seriously and are supported by board evaluation providers who add value to the process. However even among the FTSE 350, the quality and uptake of meaningful



board evaluation is mixed. In extending the board evaluation process to smaller companies, there needs to be a focus on improving board evaluations more generally. Investors want companies to develop board evaluation strategies that align with the needs of their businesses, and that are forward-looking, not just retrospective. We provided some key questions for Boards to ask themselves in order to improve board evaluations in our 2015 joint paper with EY, ["Board Effectiveness: continuing the journey"](#).

We are supportive of the removal of other exemptions for smaller companies. This change is important because, as businesses develop and grow, they will be better able to attract capital if they adopt the right governance structures.

However, we would stress that the removal of these exemptions should be seen in the context of "comply-or-explain", to account for the range of changes required of these smaller companies, and that some boards of smaller companies may consider these provision to be inappropriate for their businesses. Investors expect any explanations to be well-argued statements that link back to the strategy of the business to explain why their governance structure (and any deviation from the Code) is right for them.

**7. Do you agree that nine years, as applied to non-executive directors and chairs, is an appropriate time period to be considered independent?**

Investors use the nine-year provision as one of a range of criteria when determining the independence of directors. While length of tenure can have an impact on the independence of directors and therefore such a guideline is helpful to have, investors will also see longer tenures as appropriate in some cases.

It is important to note that individual director tenure is also assessed in the context of the overall makeup of the Board, and approach to succession planning. Therefore, many investors would consider the overall Board picture more important, and some would additionally consider looking at the average tenure of the board, as well as individual tenure, as a metric of Board independence.

Regardless of the length of their tenure, investors have the ability to vote against the re-election of the directors if they have concerns about their independence or tenure.

Provision 15 – Independence of the Non-Executive Directors

We note that the approach to independence has changed in the new Code such that non-executives will *automatically be deemed not independent* under Provision 15 if they meet the stipulated criteria. This contrasts to the current approach in B.1.1. of the existing Code that the board *determines the independence* of the director, with regard to the criteria.

We welcome this change to the Corporate Governance Code. Under the current system, investors have found that companies may provide spurious or no reason at all to justify their classification of the director as independent.

We hope that this change will instead direct companies to focus on justifying why directors have the right skills to be members of the Board if they do not meet the independence criteria of the Code, rather than focussing on the Board's determination of their independence. If a director is non-independent, Boards must set out what that individual brings to the Board to justify their Board membership and ensure that they have appropriate independent representation on the Board.

## Principle E and Provision 15 - Independence of the Chair



We note that A.3.1. of the existing Corporate Governance Code is proposed to be removed such that the Chair is expected to be independent throughout their tenure and not just on appointment.

Investors will normally assess the suitability of directors on a case-by-case basis, with reference to independence criteria among other factors. Investors have the ability to oppose the re-election of a chair if they are dissatisfied.

There is a range of views within our membership on whether or not the chair should be judged against independence criteria on an ongoing basis. We would therefore urge that this issue is considered carefully. The IA is happy to work with the FRC as the Code continues its development in this area.

The positions of members can broadly be summarised as follows:

Some of our members agree with the FRC's proposals to create an ongoing independence test for Chairs like other Non-Executive Directors, as it will clarify the role and classification of the chairman in the Code. They believe that there needs to be an ongoing assessment of independent, as the current Code is currently silent on the issue of the chair's classification on an ongoing basis, and this creates a gap between the chair and the other non-executives. They are also concerned that, in some cases, the current system has led to long-serving chairs, which is not necessarily good for overall governance and board effectiveness.

Another group do not believe that it is appropriate to apply ongoing independence criteria to the Chair, as their role is significantly different to other non-executives. Chairs spend considerable more time in the business alongside executives, making it more difficult for them to retain their ongoing independence. Chairs are also different both in terms of the ambassadorial role they fulfil, and in their pay.

A third group think that the chair could meet many of the independence criteria, however they feel that the tenure limit of nine years is inappropriate for a Chair. The concern is that extending this provision to the Chair will discourage Boards from promoting non-executives to Chairs, as their tenure as Chair may be limited by the years already served on the Board. The unintended consequence of this change may mean that all Chairs are appointed externally rather than internally. This could have an impact on overall board effectiveness, particularly in complex or international businesses, where it can be helpful for the incoming chair to have knowledge of the company before becoming chair.

Additionally, some investors see benefits in having chairs with extended tenure, to provide consistent corporate memory, particularly in periods of change in management. An alternative solution could be to allow a Chair to have an additional 3 years as independent Chair if they were appointed from the Board.

Finally, some investors believe that the Chair could be considered independent on an ongoing basis, but new independence criteria, specific to the chair, should be devised to reflect the specific role the chair fulfils.

Due to this range of views, we believe that this change to the designation of independence of Chair's on an ongoing basis should be considered carefully and the unintended consequences of such a change being carefully analysed.

## Provision 11 – Board Composition



Provision 11 has been amended to reflect the change in designation of the chair's independence, and should be revised so that it reflects the final decision on this.

However, in its current state, we believe that Provision 11 could be clarified. Currently it is not clear as to whether the chair is counted towards the majority of independent directors, whether or not they are independent. We would not expect the Chair to be included in this majority if they are not considered independent. We believe that the Code should be explicit on the composition of the Board if the Chair is not considered independent.

Therefore the revised Code should read: "Independent non-executive directors, should constitute the majority of the Board. This number can include the chair, if they are independent, otherwise the Chair should be excluded from this count".

### **8. Do you agree that it is not necessary to provide for a maximum period of tenure?**

We agree that it is not necessary to provide for a maximum period of tenure for any directors on the Board, either executive or non-executive.

For non-executive directors, considerations of independence, which refers to a period of nine years, often have the effect of limiting tenure. However, the fact that this is not a strict cut-off is important. Sometimes investors are supportive of directors who have been on the Board for more than nine years (and are therefore no longer considered to be independent based on the Code's provisions) remaining on the Board, either to manage succession transition, for the benefits of their knowledge from their extended tenure, or for managing exceptional circumstances. A mandatory limit would prevent Boards having the flexibility to keep non-executives on the Board in these circumstances.

While there is some research which indicates that executive directors with very long tenures can sometimes have a negative impact on the business, investors always assess the tenure of executives on a case by case basis. It is more important to investors that companies focus on succession planning; that they ensure that the Board has the right skills to run the company; and that no individual or group has unfettered powers on the Board; rather than setting out a maximum tenure for executives. Members will also look particularly closely at the strength of the independent challenge and oversight of boards where there has been a long-standing CEO.

In any event, for both executives and non-executives, investors have the ability to vote against the re-election of a director if they have concerns about the length of their tenure. Therefore, it is not necessary to set a maximum tenure for directors.

### **9. Do you agree that the overall changes in Section 3 of the revised Code will lead to more action to build diversity in the boardroom, in the executive pipeline and in the company as a whole?**

Investors believe that more needs to be done to encourage greater diversity on Boards. Greater diversity can encourage diversity of thought, which helps the Board's critical role in challenging and constructively supporting company strategy as well as helping to reduce the risk of 'groupthink'.

The success of market-based initiatives such as the Davies and Hampton-Alexander Reviews should be applauded. We agree that such initiatives could be further reinforced and extended by embedding the importance of diversity in the revised Corporate Governance Code (see Question 10).



The Investment Association supports the Hampton-Alexander recommendation for reporting on the number of women on the Executive Committee and their direct reports on an annual basis. IVIS (Institutional Voting Information Service), the IA's corporate governance voting research service, has also begun to include data on board, senior management and company diversity and Gender Pay Gap Reporting figures in the IVIS reports.

We have some comments on the drafting of Section 3:

- Definition of "senior management": We note that the revised Corporate Governance Code defines "senior management" as the executive committee or the first layer of management below board level. This is in contrast to the Hampton-Alexander definition, which defines "senior management" as the executive committee and their direct reports. We think this definition should be clarified to minimise confusion between the Code, other diversity initiatives and reporting requirements in law, which it aims to support.
- Provision 18: We note that this provision sets out that "specific reasons" why a director should be re-elected should be included in the papers accompanying the resolutions for their re-election. However, we feel that greater weight needs to be put on also disclosing the biographical details of directors, so that investors can also assess the skills and experiences of board members in conjunction with this explanation (this is currently required by B.7.1.). Investors are increasingly concerned with the time commitment required by directors, and the need for other appointments to be visible to investors to understand the directors' other commitments. We hope that the reasons given would explicitly consider the directors other appointments and ability to commit to their role as a director.

**10. Do you agree with extending the Hampton-Alexander recommendation beyond the FTSE 350? If not please provide information relating to the potential costs and other burdens involved, and to which companies it should apply.**

The Hampton-Alexander Review has achieved great success in improving gender diversity on FTSE 350 Boards since 2016 and continues to encourage companies to look beyond the Board to now focus on the executive pipeline. We would support the recommendations being extended beyond the FTSE 350.

As the Hampton-Alexander Review continues to show, achieving greater diversity is the right thing for companies to do and makes business sense. Increasingly, the reputational risk to companies of ignoring this presents greater costs to businesses than the cost of implementing the recommendations. Therefore it should be encouraged within all companies, to ensure they have a diversity of perspective within their organisations to make the best long-term decisions for their businesses.

**11. What are your views on encouraging companies to report on levels of ethnicity in executive pipelines?**

Investors want companies to consider diversity in the broadest sense, and take steps to make sure they have sufficient diversity of perspective on the Board. There are many approaches that have been used to improve gender diversity at board-level and

in the executive pipeline that could be applied to improving other kinds of diversity, such as ethnic diversity, such as mentoring schemes and greater assessment of the pipeline.



Ethnicity, however, is a self-defined characteristic. This presents challenges for organisations in terms of measurement and greater work needs to be done to find the best ways for companies to report on this before it is considered for inclusion in the Corporate Governance Code.

**12. Do you agree with retaining the requirements included in the current Code, even though there is some duplication with the Listing Rules, the Disclosure and Transparency Rules or Companies Act?**

The IA agrees with retaining the requirements in the current Code, even though there is some duplication with the Listing, and Disclosure and Transparency Rules, and Companies Act. As the consultation notes, reporting against the Code is sometimes used as a route for issuers to satisfy certain other requirements. This can particularly be the case for overseas issuers, and removing these requirements now could cause confusion. Additionally, as not all of the Listing, Disclosure and Transparency Rules, and Companies Act provisions apply to all of the companies that adopt the Corporate Governance Code, in some cases, there may not be duplication for some companies.

That said, the Provisions operate on a comply-or-explain basis and we would be concerned if including mandatory requirements within them impacted other Provisions where a meaningful explanation may be a more appropriate response.

It is crucial that any duplication maintains consistency, and that there is no confusion as to the requirements for companies across the different frameworks.

**13. Do you support the removal to the Guidance of the requirement currently retained in C.3.3. of the current Code? If not, please give reasons.**

We agree that this should be moved to Guidance which also clarifies that the terms of reference for all board committees should be set out clearly and be public. Moving this Provision helps to simplify the Code and shift the focus to applying the main Principles as opposed to prescriptive compliance with the Provisions. What is particularly important is that the main roles and responsibilities of the audit committee are clear and these are set out in new Provision 25.

**14. Do you agree with the wider remit for remuneration committee and what are your views on the most effective way to discharge this new responsibility, and how might this operate in practice?**

We are supportive of a wider remit for the remuneration committee. Disconnect between how remuneration is set for executives and for the rest of the workforce can cause problems, and investors want companies to consider the executive remuneration policy in the context of the company as a whole. For the last two years in [our annual letter to FTSE 350 Chairs](#) we have asked them to begin publishing pay ratios, and to explain how their executive pay is appropriate to their wider company context.

Additionally, workforce pay is a crucial element of the management of the company, and understanding and valuing their human capital is important to the Board when looking to the long-term success of the company. With additional requirements such as Gender Pay Gap Reporting and pay ratios being introduced, it is more important than ever that the remuneration committee have oversight of the broader pay culture across their organisation, as these issues are increasingly significant risks to a

company's reputation. Therefore it is important that the whole Board has oversight of this, with the remuneration committee taking a particular interest.



We would suggest an amendment to the current wording in Provision 33 on this point, as it currently suggests that the main reason for the remuneration committee's oversight of remuneration and workforce policies and practices is to take them into account when setting director pay. While this is one reason for understanding workforce pay, we would argue that it should also link to the need for the remuneration committee to oversee the role of remuneration and culture throughout the organisation, which is broader than just influencing the setting of executive pay.

While we do support this wider role for the remuneration committee, this role needs to be carefully defined in the Code. The members of the remuneration committee are non-executive directors, and it is not their role to set pay levels across the company. Instead their role should be one of oversight of the management of employee pay.

As highlighted in Question 9, a consistent definition of "senior management" should be used in Principle P and Provision 33 to align with its use across the Code.

### **15. Can you suggest other ways in which the Code could support executive remuneration that drives long-term sustainable performance?**

Investors want remuneration committees to create the right remuneration structures for their businesses and strategy, which clearly links pay to the long-term success of the business. This has been a particular focus of market and public attention over the last two years through the work of the [Executive Remuneration Working Group](#) in 2016, and has received attention from Government in its Green Paper on Corporate Governance, and from the BEIS Select Committee in 2017.

We do not believe that there should be a one-size fits all approach to executive remuneration, and therefore are cautious about including specific provisions in the Corporate Governance Code on how companies should link pay to long-term performance. The role of the Code in supporting this should be related to the governance of remuneration, both through the Remuneration Committee and the Board.

In relation to structures of pay, the [Investment Association's Principles of Executive Remuneration](#) brings together investor expectations, and is annually revised to reflect changes to market practice. As the Corporate Governance Code is not revised so regularly, we would have concerns about references to pay structures in the Code becoming outdated, as market practice continues to change. The Corporate Governance Code should instead focus on the governance of pay rather than setting out structures of pay.

#### Experience of the remuneration committee chair

We support the addition of Provision 32, which expects remuneration committee chairs to have served on the remuneration committee for at least 12 months. However, we would clarify that this Provision should state explicitly that their experience is on **the** remuneration committee that they go on to chair, not just another remuneration committee.

This measure was included in our revision to the Principles of Remuneration in 2016, following the recommendations of the Executive Remuneration Working Group. We share the belief of the Working Group that it is important for remuneration committee chairs to have extensive knowledge of the company in order to carry out this role.

Remuneration committee chairs need time to understand the Company strategy and what drives performance, culture of the company, the shareholder base and the wider workforce population. They also need to build their relationships with the management team in order to effectively discuss these often emotionally-charged performance-related issues. The 12 month period also allows for sufficient induction into the role.

#### Extending holding periods

We note the inclusion of Provision 36, to extend standard vesting and holding periods for long-term incentive schemes to five years in total. This is the current market norm and is included in the IA Principles of Remuneration.

#### Provision 40

We are concerned that some of the characteristics listed in Provision 40 will direct companies to choose particular structures. For example “predictability” can only be achieved with some, more certain, structures and not others. Additionally, the wording on “clarity” should be amended, as it currently suggests that structures should “facilitate” engagement. Structures cannot facilitate engagement, but they can be transparent to allow investors to understand them and therefore promote effective engagement with the company on them where necessary.

### **16. Do you think the changes proposed will give meaningful impetus to boards in exercising discretion?**

Investors are keen that, in addition to formal mechanisms such as malus and clawback, companies assess outcomes to make sure they are appropriate to the performance of the business. Indeed, the [Investment Association Principles of Remuneration](#) state that “Shareholders discourage the payment of variable remuneration to executive directors if the business has suffered an exceptional negative event, even if some specific targets have been met”. Having this expected approach reinforced in the Code is helpful.

However there is some ambiguity in the drafting of the revised Provision 37, as it states that “Remuneration schemes and policies should provide boards with discretion to override formulaic outcomes”. It needs to be made clear that schemes should not have unlimited discretion attached to them. As the Investment Association Principles of Remuneration state, “discretion should only be exercised within the previously agreed boundaries and maxima”. This new provision should be clarified such that remuneration committees are not being asked to include unlimited discretion in schemes and policies to alter outcomes.

Additionally, we believe that the Code should focus on how remuneration committees should approach discretion from a governance perspective. Setting out remuneration structures should include discretion is of no use, unless remuneration committees exercise this discretion in a responsible and meaningful way. Investors want remuneration committees to assess “formulaic outcomes” and consider whether they reflect the performance of the business and the shareholder experience. Following this assessment, the discretion afforded to them in remuneration policies should be exercised as appropriate.

#### **Additional points on the drafting of the revised Corporate Governance Code**

Some additional feedback on the drafting of the Code, which does not naturally fit within our answers to other questions, is set out below.

## Viability Statements

We note that Provision 31 restates the existing Provision C 2.2. of the current Code and requires the board to prepare a “viability statement”. These disclosures are valuable to the IA’s members. They provide a company with risk capital and want to understand how that company puts that capital to use and its prospects over the long-term. Confirming that the company will continue in operation and meet its liabilities is particularly important for investors, including bond investors, in ensuring that companies do not abuse their limited liability protection.

As drafted, the period over which prospects are assessed forms the basis for the viability assessment. Undoubtedly these matters should be closely linked and if done well should give investors valuable insight into the company’s strategy, business plans, and any associated risks. However, we would be concerned if the requirement to assess viability resulted in the disclosure of principal risks being limited or discouraged directors from taking appropriate levels of risk as part of their medium/long-term business strategy.

Investors want companies to give them an insight into their plans for the future which may be separate from the plans that support the viability statement. To facilitate this, the assessment of prospects in the Code should be decoupled from the assessment of viability. The former then gives the board the opportunity to demonstrate that it has considered the future of the business over the long-term. This may be particularly relevant for industries with long-term contracts or assets, for example, pension providers and extractive industries. In this context, we draw your attention to the [IA’s Guidelines on Viability Statements](#) which set out the expectations of institutional investors to help companies with these disclosures. The FRC could also consider referencing the work of the FRC Lab on Viability Statements from November 2017 in the Board Effectiveness Guidance.

## Audit Quality and Effectiveness

Provision 26 requires that in describing the work of the audit committee, the annual report sets out how it assessed the effectiveness of the external audit and matters such as the approach to appointment and reappointment, tenure etc.

Investors value an annual report and accounts that it is subject to an independent, quality audit so that the markets can trust the information reported. Given the importance of audit quality to the capital markets and the range of factors that can impact it, we consider it important that the audit committee not only assesses the auditor’s effectiveness but also the quality of the audit and that this should be clarified in the Code.

In addition, the Code should reference the importance of the audit committee engaging with shareholders on this issue. Investors are keen to engage on audit quality, significant accounting judgements that have been made during the year, and on how the audit committee is overseeing the risk and control environment of the businesses they invest in.

## Audit Committee Whistle-blowing Arrangements

We note that Provision C.3.5., which provides for the audit committee to have arrangements for staff raising concerns relating to possible improprieties in matters of financial reporting or other matters, has been folded into Provision 3, which discusses the establishment of general whistle blowing mechanisms.

We do not think this is sufficient, and believe that a separate mechanism directly relating to the audit committee should be maintained. Investors want there to be a

direct channel between employees and the audit committee to allow improprieties in financial reporting to be reported.



### Board Size

The current version of the Code references the fact that the Board should not be so large as to be unwieldy (B.1. Supporting Principle). Members have reported to us that they found this a helpful piece of guidance to make sure that boards are not too large.

## SECTION 2 – QUESTIONS ON THE STEWARDSHIP CODE



The UK is recognised internationally as being leaders on stewardship. For many decades, UK institutional investors have believed that working with investee companies to ensure the long-term success of those businesses for the benefit of their end clients is essential.

The creation of the UK Stewardship Code in 2010 reflected the steady growth of stewardship as a key part of the investment process. Stewardship is an important part of the investment process for many investors, and as such is an area to which many of them will devote significant resource. The Code has, since its inception, played an important role in setting best practice expectations for investor stewardship, but it is important that it is now carefully reviewed to make sure it continues to support investors as stewards and keeps pace with market developments.

There are elements of the Stewardship Code that could be improved to help to grow stewardship activities in the UK, and we welcome the opportunity to contribute to the 2018 review of the Stewardship Code to develop the Code further. We also note that the Shareholder Rights Directive (which will be implemented in the UK by June 2019) will necessitate some amendments to the Stewardship Code and the way that Asset Managers and Asset Owners report on their stewardship policies and activities.

### Investment Association View of the Stewardship Code

The review of the Stewardship Code should start with a clear acknowledgement of the purpose of the Stewardship Code. We believe that the Stewardship Code's role is to provide broad, high-level principles of good stewardship. The Investment Association hopes that the full review, which is due to follow this preliminary consultation, is framed by this overarching purpose.

In its current form, the Stewardship Code has generally met its objective, however, it should evolve to reflect how stewardship practice has developed, and could, in some areas, be improved. For example, the current Code predominantly focuses on governance issues, investments in equities, the role of asset managers and proxy voting. Stewardship encompasses a much greater range of activities, actors in the investment chain, and topics.

We would, however, stress that the strength of the Stewardship Code lies in its simplicity, and the fact that it is universally applied. This essence must also be maintained.

It is essential that the Code maintains its high-level principles approach, and does not prescribe specific activities or topics that investors must comply with. Good stewardship relies on investors choosing the right approach and issues to engage on. These will change dependent on the individual circumstances of their investments. Stewardship cannot and should not be boiled down to a checklist.

### Stewardship beyond the Stewardship Code

It is also crucial to recognise that the Stewardship Code focuses on policies, which is only one element when it comes to improving stewardship. In order to continue to grow stewardship in the UK and improve its effectiveness, we believe that any amendments to the Code need to be accompanied by changes to the environment in which stewardship operates.



Firstly, **a better market for stewardship needs to be created.** End clients and the public need to understand what stewardship is and what role it plays in order for there to be greater demand for it. The 2017 Stewardship Survey found that 16% of pension fund respondents had no opinion on whether pension funds have stewardship responsibilities<sup>1</sup>. This often weak demand from asset owners for stewardship means that more needs to be done so that stewardship is a key part of the discussions on the service asset owners are getting from asset managers and so that there is an assessment of the quality of their stewardship services received. In order for investors to have the resources to effectively carry out their stewardship duties, client demand for investors to prioritise stewardship is key, particularly in an environment where costs are a key consideration for the end investor.

**A more demanding and discerning client base will help to develop market practice and increase competition in the industry on stewardship.** This can be created with better education for clients and the wider public of what stewardship is, why it is important and what it means in practice. Stewardship and long-term investment factors should also be better incorporated into the mandate design, which sets out the relationship between asset managers and asset owners.

It can also be achieved by focussing on **improving and drawing attention to the public disclosure of stewardship activities** by investment managers. By being more open about how they conduct stewardship, investors can also help to create awareness of the value of stewardship, and allow clients to identify the different approaches of different asset managers. While many of our members already produce extensive public documents relating to their stewardship activities, there is a range of practices across the market.

The Investment Association will continue to work with its members to improve this disclosure. A key part of this is the [Stewardship Reporting Framework](#), which was developed as part of the Productivity Action Plan to provide a basis for public reporting of asset managers' stewardship activities, and helps asset managers to report on their reporting in a consistent way through a mix of summary statistics and case studies on both engagement and voting. The IA is working to further develop the Stewardship Reporting Framework to make it a useful tool for improving disclosure.

Another point that needs to be addressed is the awareness of **the definition of stewardship**, and how it relates to other concepts such as ESG (environmental, social and governance issues). Stewardship encompasses the acts the investors carry out when looking to ensure the long-term success of their investments. While carrying out stewardship, investors may focus on ESG topics, where they are relevant to long-term issues of the company, but they are also likely to focus on strategy and other aspects of their investment. It is therefore important to note that the topics involved in stewardship can be wide-ranging and will depend on the investment in question, and also the investment approach of the investor.

The Investment Association would welcome the opportunity to work with the FRC to make sure that the revised Stewardship Code helps to support the growth of stewardship. We have responded to the questions below, and made further suggestions on how the Code could be improved.

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<sup>1</sup> Stewardship Survey refers to The Investment Association and PLSA 2016 report "[Stewardship in Practise](#)"



**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 agree that the Stewardship Code could be more explicit about the obligations for other constituents of the investment chain beyond asset managers, for example the obligations for asset owners and service providers such as investment consultants and proxy advisors should be included. As the introduction of the Stewardship Code notes, asset owners “set the tone for stewardship”, and it is important that their role in the investment chain is reflected adequately in the Stewardship Code.

As we have set out above, we believe that a key aspect to improving stewardship is by setting out more clearly the role of asset owners in regards to stewardship. If asset owners are more engaged in their stewardship responsibilities, they are, in turn, more likely to be more explicit about stewardship in mandates, and to assess the quality of asset managers’ reporting on stewardship. This will help to drive a better market for stewardship.

We would support specific provisions for asset owners and other parts of the investment chain being included in the existing Stewardship Code. We believe that by adding specific provisions for asset owners and service providers, all elements of the Stewardship Code will understand their responsibilities in regard to stewardship and will be more engaged. Asset owners are a fragmented group and have a wide range of fiduciary duties, so it would be helpful to clarify their role in stewardship. We would not be in favour of a proliferation of different codes for different actors in the chain, as this could cause confusion.

Including these specific provisions in the Code is likely to be accompanied by an upcoming regulatory underpin driven by the Shareholder Rights Directive. There is already a requirement for asset managers from the FCA to disclose the nature of their commitment to the Stewardship Code, and we support the introduction of a similar requirement is introduced for asset owners to meet the provisions of the Shareholder Rights Directive.

**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?**

Stewardship is part of the investment process, which varies from firm to firm based on their commercial business model, and is determined by the needs of end clients. As we have set out above, the role of the Code is to set out broad, high-level principles on good stewardship.

We believe that it is therefore not appropriate to set out specific roles, structures and expectations for how investors carry out their stewardship duties. This could stifle innovation in stewardship. Additionally, it is up to clients to determine whether they are satisfied that their asset manager has taken the right approach on stewardship.

For these reasons, we would support the maintenance of the existing focus of disclosure and transparency, rather than applying explicit roles, structures and expectations for stewardship. As we have stated above, instead of focussing on setting out specific stewardship activities considered as best practice in the Code, we would advocate that it is more important to focus on drawing attention to what best practice stewardship looks

like, and making clients more discerning, so that they are able to judge the quality of stewardship between different investment managers.



**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?**

The 2016 tiering exercise was a useful exercise for assessing the policy statements of signatories, which lead to significant improvements in the public disclosures of signatories policies. However, it did not address the reporting of stewardship activities, nor the substantive delivery of stewardship that needs to underpin that reporting.

The FRC's primary responsibility in relation to the Stewardship Code is on Stewardship Code statements, which address policies on stewardship. Given that these are high-level statements on the signatories policies, we do not believe there is a need to have an additional focus on these statements. Signatories can already look at the best practice of Tier 1 signatories to see where their own statements can be improved.

It may be helpful for the FRC to outline in some guidance what key characteristics of Tier 1 statements it identified during the tiering exercise, to showcase what best practice statements looks like. The FRC could also consider other ways of identifying best-in-class signatory statements, for example through awards or commendations.

Instead, we believe that the aim should be to look now to improving public reporting of stewardship activity. Please see our answer to Question 23 for our suggestions on how this might be done.

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

The Stewardship and Corporate Governance Codes are closely linked and support each other. The Corporate Governance Code sets out the expectations for boards and companies while the Stewardship Code sets out the principles of effective stewardship by investors, which involves interaction with boards and companies.

The Guidance for Principle 3 explicitly notes that institutional investors should satisfy themselves that boards are adhering to the spirit of the UK Corporate Governance Code. Therefore the revisions to the Corporate Governance Code, such as on diversity and culture, flow through to the Stewardship Code in its current form and investors will be closely assessing their investee companies to assess how they are applying the revised Code.

While the Stewardship Code and Corporate Governance Codes have a close relationship to one another, they are different in nature. The Stewardship Code reflects a process that operates within the client relationship between the asset manager and asset owner. Investment managers must exercise their stewardship duties within this commercial relationship, and it is the investors' primary duty as stewards to deliver the best long-term returns for their clients.

This means that it is important the Stewardship Code remains high-level to allow for the different business models and client relationships of different investors. It also means that many aspects of the Corporate Governance Code would not be appropriate to include in the Stewardship Code because they would prevent investors having the flexibility to act primarily for the benefit of their clients.

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



In the Investment Association's [Productivity Action Plan](#), which was published in 2016, it was highlighted that the Stewardship Code could be strengthened to promote long-term value creation through shareholder engagement. Promoting the long-term success of companies is currently only referenced in the preamble to the Code, and does not appear in the Principles or supporting Guidance.

Principles 1 and 3, which relate to investors overall stewardship policies and to their monitoring of investee companies, should make greater reference to the link between stewardship and long-term value creation. We believe that the drafting changes necessary to achieve this would be minimal, but would emphasise the relationship between stewardship and long-termism.

## **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?**

ESG issues can impact on the long-term value of companies, and investors are increasingly taking account of how companies are addressing material ESG risks to their business. While assessing companies based on ESG criteria and their relationships with wider stakeholders are often significant components of investor stewardship activities, we do not think that it is appropriate to refer to explicit ESG factors or 'wider stakeholders' in the context of the Stewardship Code.

Investors consider ESG factors and other issues such as social impact due to their duties to their clients, rather than having responsibilities for ESG factors *per se*. The Stewardship Code is a framework that works within the investor-client relationship, and the investors' role as stewards is to deliver the best long-term returns for their clients. It is a misunderstanding of the investor-client relationship, from where stewardship originates, to talk about investors having general duties in relation to 'wider stakeholders' or ESG factors.

Additionally, by codifying certain issues that investors must engage on, such as ESG and social impact, it ignores the fact investors as stewards must decide what issues are most material to the long-term success of their investments and engage on these points, rather than referring to an arbitrary list of topics. Including a list of factors that investors must engage on risks creating a compliance approach to stewardship and may prevent investors prioritising the material long-term risks to engage on.

As we have argued in our answer to question 3, investors are very supportive of the move to make sure that boards are taking account of the views of their stakeholders, to make sure that boards can have the information they need to make long-term decisions that will ultimately benefit investors. We expect that the soon to be implemented reporting requirements on s.172 and stakeholder engagement requirements which are being introduced to the Corporate Governance Code will naturally increase the level of shareholder engagement on these issues, as more information is available to shareholders on investee company approaches.

### **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?**



As we have identified above, we believe that the key to improving and developing stewardship is to drive innovation in how stewardship activities are communicated. While the success of some aspects of engagement depend on them happening in private, investors understand that they need to evidence their stewardship activities and ultimately the effects of their stewardship activities on company behaviour.

Investors already provide extensive reporting to their clients, and our members have reported to us that, in recent, years client interest in stewardship has increased. As investors carry out stewardship for the benefit of clients, this will remain the most important part of their reporting on their stewardship activities.

However, evidencing stewardship more publicly is key to driving greater understanding of the importance of stewardship, and improving the quality of stewardship by creating a better market for it.

Many of our members already provide extensive public reporting of their activities. This typically includes summaries of key engagements carried out during the year, including an overview of the underlying issue, the approach to engagement and result of the engagement process. Members also outline their voting activities. The frequency and content of public reporting varies from firm to firm.

For this reason, the IA produced the [Stewardship Reporting Framework](#) as part of the Productivity Action Plan. The Stewardship Reporting Framework serves as a basis for public reporting of asset managers' stewardship activities, and helps asset managers to report on their reporting in a consistent way through a mix of summary statistics and case studies on both engagement and voting.

In a recent review of the reporting of the top 30 asset managers by UK equity holdings, the IA found that 22 (73.3%) were reporting in line with the Stewardship Reporting Framework. 26 of the top 30 release their voting records.

Due to the requirements of the Shareholder Rights Directive, it is likely that investors will be considering how to publicly disclose the implementation of their engagement policy, specifically with regard to voting. The Investment Association is working with members to consider the implementation of this requirement.

The Investment Association is planning to review the Stewardship Reporting Framework to see if it can be improved, so that it provides a useful tool that asset managers use to present their engagement activity. After the Stewardship Reporting Framework has been reviewed and updated, we will undertake another assessment of how asset managers are applying it, and look to see if there is anything else that would help to develop market practice in public reporting.

Some members of the IA have also previously used the NAPF (now PLSA) Stewardship Disclosure Framework, and found this to be helpful. The Investment Association intends to engage with the PLSA to see how the two frameworks can be reviewed and support each other.

## **24. How could the Stewardship Code take account of some investors' wider view of responsible investment?**



The FRC are right to note that many investors do not limit their stewardship approach to equity, and consider themselves to be responsible investors more generally.

The Stewardship Code originates in relation to equity, and equity is the area where investors do have significant voting rights and opportunities to engage with investee companies as a result. However some investors do consider other asset classes within their stewardship activities. Asset managers will work with their clients to understand their expectations on responsible investment to develop their approach.

Rather than having a specific responsibilities or guidance for different asset classes, it may, be appropriate for the Stewardship Code to ask signatories to disclosure how they exercise their stewardship responsibilities for other asset classes. This will allow those companies that have policies and approaches to stewardship for different asset classes the opportunity to explain how they fulfil those stewardship requirements.

## **25. Are there elements of international stewardship codes that should be included in the Stewardship Code?**

The Investment Association notes that the number of stewardship codes internationally has proliferated, and that many investors who invest globally may be signatories to multiple stewardship codes. The UK Stewardship Code has lead internationally, with many other jurisdictions using the UK Code as a basis for their stewardship codes.

In order to meet the needs of clients, investors will choose which stewardship codes to adhere to and how to make the necessary statements in a way that suits their business model. It may be helpful for the Stewardship Code to be more explicit in stating that signatories can use their statement to adhere to multiple Codes, as some investors will only want to make one statement for multiple codes.

On the suggestion of referencing explicit guidance on stock lending policies, we believe that the current comply-or-explain policy is sufficient to capture the range of approaches across the market. Investors are able to explain why stock lending does, or does not, suit their business approach, and clients are able to see this as part of their Stewardship Code statement, and make a judgement as to whether they support this approach.

On including greater reference to ESG factors in the Stewardship Code, please refer to our answer to Question 22.

## **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?**

The current provisions in the Stewardship Code could be improved, as many members have reported to the IA that they do not find the current provision of independent assurance to be beneficial. Members are of the view that independent assurance rarely produced rigorous or insightful review of their Stewardship practices, and report that the assurance market is insufficiently developed for external parties to provide meaningful insights. Moreover, members reported having difficulty using their independent assurance reports for client reporting or wider demonstration of their adherence to the Stewardship Code.

By contrast, several institutions reported that they valued the reviews conducted by their internal audit functions far more than the independent assurance exercises. The

Stewardship Code could recognise the role that independent audit can play in helping investors review their stewardship code responses and processes.



We would support a review of the independence assurance process to make sure that it is providing real value to signatories and to the clients of signatories.

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

Directed voting in pooled funds is an issue relating to client choice both between different asset managers and between the specific services they offer, and consequently is not something that should be addressed in the Stewardship Code.

Clients have a choice to use pooled funds or segregated mandates. Those clients who choose to use a pooled fund are usually informed that their shares will be voted in accordance with the institution's voting policy. Pooled funds often have benefits such as being lower in cost, and that the aggregate weight of the fund's vote can have a more significant impact. If a client wants to use directed voting then they are able to use a segregated mandate.

Members have raised some potential technical and legal issues with directed voting in pooled funds. The Investment Association will work with members and other parties to identify and review these issues more fully.

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

Investors will engage on a range of governance issues that they believe are material to their investee companies. Investors believe that companies need to make sure they have a diverse range of view points in the boardroom to avoid 'groupthink' and provide sufficient challenge (see Question 9). Diversity is an important business issue and is therefore a relevant concern when assessing the long-term view of a company. It is therefore an issue relevant to stewardship.

However, as we set out earlier in our response, the Stewardship Code is a high-level code which should not set out what issues investors should be engaging on. Investors will engage with companies on the issues that are materially relevant to that company and most in the interests of their clients, rather than engaging on a particular issue in all cases. For example, where a company has already achieved sufficient diversity in the investors' view, it would be unnecessary to prioritise engagement on the topic. Setting out specific expectations on particular topics such as diversity is not the right approach given investor duties to their clients, and may also set out too narrow a view of stewardship that restricts innovation.

Investors will continue to support initiatives to improve diversity in investee companies, however the Stewardship Code is not the correct framework to underpin investor focus on this.

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

Investors will engage on a range of ESG issues, including, in many cases, on issues relating to climate change. However, as we set out in the introduction to this question and Questions 23 and 28, the Stewardship Code is a high-level Code and we believe that

it would be both inappropriate and detrimental to set out a list of issues that investors are expected to engage on.



Investors must choose the issues that are most material to insure long-term returns to their clients. Setting a menu of issues that investors must review ignores this duty.

In addition, the issues that investors are considering in relation to stewardship have changed over time, and will continue to evolve. Setting a list of issues is too rigid and would prevent investors being able to adapt to future challenges that may affect the long-term prospects of their investments in the future. We expect that investors will engage with companies on addressing climate change risk when it is material to the Company.

**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?**

As part of their response to Principle 1, and in explaining what their policy on stewardship is, we believe that it would be beneficial for signatories to set out why stewardship is important to them, and how it relates to their investment process.

In the Stewardship Reporting Framework, we note that asset managers should set out the context of the individual manager's approach to stewardship. Asset managers are encouraged under the Framework to describe how the stewardship activities that they report this framework relate to their investment process and individual circumstances of their firm.

**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?**

We do not believe that this would be helpful or produce significant change. Requirements for the disclosure of additional information relating to funds could lead to an overall reduction in the number and quality of stewardship code responses.

On the whole, members use their entire holding in a company to exert their influence on stewardship issues, even though this could be held across many funds. Stewardship policies are usually set at an institutional level and would be the broad basis for all funds.

We believe that being a signatory by fund could reduce the influence of the fund on company behaviour, and could be more confusing for companies that are trying to understand the approach of their investors. There is already tension and resource issues for institutional investors around being signatories to multiple stewardship codes around the world; requiring signatories at the fund level will increase this complexity and resource tension.